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THE WAR PROFITEERING PROHIBITION ACT OF 1985

HEARING

BEFORE THE

SUBCOMMITTEE ON
GENERAL OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

ON

H.R. 3020

A BILL TO REVISE AND REINSTATE THE RENEGOTIATION ACT OF 1951

OCTOBER 30, 1985

Serial No. 99-53

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CONTENTS

Page

Text of H.R. 3020 4
    Changes in Existing Law Made by the Bill, as Reported 8
    Summary of legislation 7

WITNESSES

Grenough, Donald S., partner, Touche Ross & Co 165
    Prepared statement 170
Kaufman, Richard F., general counsel, Joint Economic Committee 108
    Prepared statement 114
Math, Paul F., Associate Director, National Security and International Affairs Division, U.S. General Accounting Office 45
    Prepared statement 48
Mulligan, Richard G., chairman, committee on government business, Financial Executives Institute 151
    Prepared statement 156
Spector, Eleanor R., Deputy Assistant Secretary of Defense for Procurement, Department of Defense 17
    Prepared statement 31
Tolley, William R., director of legislative affairs, Harris Corp 134
    Prepared statement 142

MATERIAL SUBMITTED FOR INCLUSION IN THE RECORD

Gonzalez, Hon. Henry B., questions submitted to witnesses with attached responses:
    Richard F. Kaufman 67
    Paul F. Math 66
    Eleanor R. Spector 62
Kaufman, Richard F., response to questions of:
    Chairman Carroll Hubbard 128
    Hon. Henry B. Gonzalez 67
Math, Paul F., response to questions of Hon. Henry B. Gonzalez 66
National Presto Industries, Inc., statement entitled "A Grim Fairy Tale" 137
Spector, Eleanor R.:
    Charts: "Renegotiation Board, Statistical Abstract, 1953-78" 19
    Response to questions of:
        Chairman Carroll Hubbard 56
        Hon. Henry B. Gonzalez 62
        Hon. Marcy Kaptur 103
        Hon. George C. Wortley 94
Tolley, William R.:
    "A Grim Fairy Tale," statement by National Presto Industries, Inc 137
    "Vinson-Trammell—An Anachronism," article from the National Contract Management Quarterly Journal, dated September 1978 196

APPENDIX

Kirk, Alexander, statement 363
Letters of invitation to witnesses 217
Machinery and Allied Products Institute, statement with attachments 328

Page

Staats, Hon. Elmer B., Comptroller General of the United States, letter to Hon. William Proxmire, chairman, U.S. Senate Committee on Banking, Housing and Urban Affairs, dated September 10, 1977, with attached report "Results of Review of Individual Company and Industry Association Estimates of the Costs of Compliance With the Renegotiation Act" 226

WAR PROFITEERING PROHIBITION ACT OF 1985

WEDNESDAY, OCTOBER 30, 1985

House of Representatives,
Subcommittee on General Oversight and Investigations,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Carroll Hubbard (chairman of the subcommittee) presiding.

Present: Chairman Hubbard; Representatives Gonzalez, Barnard, Kaptur, Parris, Wortley, Bartlett, Chandler, and McCandless.

Chairman **Hubbard.** The Subcommittee on General Oversight and Investigations of our House Banking, Finance and Urban Affairs Committee will now come to order.

On behalf of all of the members of our subcommittee, I want to welcome you here today to our hearing on defense contracting and H.R. 3020. The subcommittee is conducting hearings today, and also at a future date not yet determined, on H.R. 3020, the War Profiteering Prohibition Act of 1985.

H.R. 3020 was introduced on July 17, 1985, by my good friend and our distinguished colleague from Texas, Representative Henry B. Gonzalez, for the purpose of revising and reinstating the Renegotiation Act of 1951.

The process of renegotiation was originally devised via the Renegotiation Act of 1942, and was designed as a mechanism to prevent the realization of excessive profits on defense contracts and subcontracts. The 1942 act extended the principle of profit limitation to war contracts generally.

From 1942 until the Renegotiation Act of 1951, successor statutes were enacted in 1943, 1945, and 1948, with the latter representing the first peacetime renegotiation statute.

During the Korean war, Congress passed the Renegotiation Act of 1951, which created the Renegotiation Board and which has been extended 13 times by Congress. The last extension was enacted in 1975, and the law continued in effect until September 30, 1976, when it expired. The Renegotiation Board ceased operations on March 31, 1979, after receiving additional appropriations from 1976, in order to address its backlog of cases. I am certain the Board will be discussed in much greater detail during the course of our hearings today and again later.

Jurisdiction over the Renegotiation Act was transferred from the House Ways and Means Committee to our full Banking Committee on January 14, 1975. Pursuant to our oversight authority, this subcommittee has conducted numerous hearings on the act over the past 10 years, the most recent of which was held on March 21, 1984, and titled "Oversight Hearings on Profits on Defense Contracts."

The members of our subcommittee and I believe our hearings on defense contracting and pending legislation are indeed timely. Certainly, these hearings will only be a part of congressional actions on and studies of our Nation's defense policies.

By way of background, during President Reagan's first term Congress heeded his call to rearm the Nation by giving the Pentagon $1.1 trillion to spend, a 36-percent increase after inflation. Because of scandals over $436 hammers and $600 toilet seats and squeezed by the record-level Federal budget deficits, we are now questioning increasingly whether the United States and its taxpayers are getting their money's worth in the most costly peacetime rearmament program in our Nation's history.

The House Committee on Armed Services, chaired by Congressman Les Aspin, has launched a series of hearings addressing the question, "What have we got for $1 trillion?" The Armed Services' hearings are intended to be a wide-ranging examination of Pentagon policy and will be used to determine whether the U.S. Defense Department is wisely spending its money, or I should say "our" money.

Former Deputy Secretary of Defense David Packard, who chairs a 15-member Presidential Commission appointed to look into charges of Pentagon waste and management, believes that "fundamental" changes should be made in the way the Pentagon buys weapons. The Presidential Commission is expected to send its own recommendations for reform to the White House in December of this year.

On October 16, the Senate Committee on Armed Services released a massive, 645-page report calling for sweeping structural changes in the Department of Defense.

The U.S. General Accounting Office has advised Congress that it is conducting an audit of Department of Defense contractors to discover the reasonableness of subcontracting costs negotiated under prime contracts, the adequacy of Defense Department surveillance of contractors' cost-estimating methods and practices, and the adequacy of Pentagon technical reviews of contractors' price proposals, unpriced contracts and overhead costs.

Clearly, the issues of defense spending, procurement, and abuses of taxpayers' dollars are indeed important to our subcommittee, to our Banking Committee and the 99th Congress.

Our General Oversight and Investigations Subcommittee is concerned with resolving questions about whether renegotiation should be only a wartime mechanism, determining if the dynamics of modern full-time defense procurement mandate the need for permanent postcontract review.

We are all familiar with the issues surrounding defense procurement and renegotiation, and we are also cognizant of the $314.4 billion defense budget proposed by the administration for fiscal year 1986. When dealing with a defense budget of that magnitude, it is imperative that Congress consider every possible alternative to curb wasteful and excessive spending by our Federal Government.

American taxpayers deserve that, and our hearing today is being conducted for that purpose.

Our objective is to ascertain how present laws and procedures detect unreasonable or excessive profits in defense contracts, and whether our Government has adequate recourse to recover excessive, unreasonable or unwarranted profits by defense contractors. Specifically, we shall address the question: Should the Renegotiation Act be revitalized?

We look forward to hearing the testimony of today's witnesses to aid us in our consideration of H.R. 3020.

[The text of H.R. 3020, a summary of the bill, and information showing proposed changes in the legislation follows:]

99TH CONGRESS
1ST SESSION

H. R. 3020

To revise and reinstate the Renegotiation Act of 1951.

IN THE HOUSE OF REPRESENTATIVES

JULY 17, 1985

Mr. GONZALEZ introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

---

A BILL

To revise and reinstate the Renegotiation Act of 1951.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "War Profiteering Prohibition Act of 1985".

SEC. 2. Section 102 of the Renegotiation Act of 1951 (50 U.S.C. App. 1212) is amended by adding at the end thereof the following:

"(f) CERTAIN AMOUNTS RECEIVED AFTER OCTOBER 1, 1985.—Notwithstanding the provisions of subsection (a), the provisions of this title shall not apply to contracts with

Departments, or related subcontracts, to the extent of the amounts received or accrued by a contractor or subcontractor during the period beginning on October 1, 1985, and ending on the date of the enactment of this subsection.".

(b) The last sentence of section 102(c)(1) of the Renegotiation Act of 1951 (50 U.S.C. App. 1212(c)(1)) is amended to read as follows: "For purposes of this title, the term 'termination date' means September 30, 1988.".

(c) Section 105(a) of the Renegotiation Act of 1951 (50 U.S.C. App. 1215(a)) is amended by inserting after the sixth sentence thereof the following: "The Board shall renegotiate all contracts and subcontracts by division and by major product line within a division of the contractor or subcontractor.".

(d) Section 105(f) of the Renegotiation Act of 1951 (50 U.S.C. App. 1215(f)) is amended—

(1) in paragraph (1), by inserting ", or $4,000,000 in the case of a fiscal year ending after the date of the enactment of the Renegotiation Act Amendments of 1985" after "June 30, 1956" each place it appears therein;

(2) in the second sentence of paragraph (3), by inserting "the $5,000,000 amount," after "the $1,000,000 amount,"; and

(3) in the last sentence of paragraph (3), by striking out "$1,000,000" each place it appears therein and inserting in lieu thereof "$5,000,000".

(e) The amendments made by this section shall take effect on the date of the enactment of this Act.

H.R. 3020 - To revise and reinstate the Renegotiation Act of 1951

Section 1, Self explanatory.

Section 2, (a) and (b), Reflects date changes only.

Section 2, (c), Provides additional clarification to the section describing the renegotiation proceedings before the Renegotiation Board.

Section 2, (d), (1), (2), (3), Provides for updated dollar amounts which reflect updated expenditures. Please note the $4,000,000 is a typographical error. The amount should state $5,000,000.

H.R. 3020 contains no substantive changes to the Renegotiation Act of 1951.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

RENEGOTIATION ACT OF 1951

WAR PROFITEERING PROHIBITION ACT OF 1985

* * * * * * *

TITLE I—RENEGOTIATION OF CONTRACTS

* * * * * * *

SEC. 102. CONTRACTS SUBJECT TO RENEGOTIATION.

(a) IN GENERAL.—* * *

* * * * * * *

(c) TERMINATION.—

(1) IN GENERAL.—The provisions of this title shall apply only with respect to receipts and accruals, under contracts with the Departments and related subcontracts, which are determined under regulations prescribed by the Board to be reasonably attributable to performance prior to the close of the termination date. Notwithstanding the method of accounting employed by the contractor or subcontractor in keeping his records, receipts or accruals determined to be so attributable, even if received or accrued after the termination date, shall be considered as having been received or accrued not later than the termination date. For [the] purposes of this title, the term "termination date" means [~~September 30, 1976.~~] *September 30, 1988.*

* * * * * * *

1985

(f) CERTAIN AMOUNTS RECEIVED AFTER OCTOBER 1, ~~1976.~~—Notwithstanding the provisions of subsection (a), the provisions of this title shall not apply to contracts with Departments, or related subcontracts, to the extent of the amounts received or accrued by a contractor or subcontractor during the period beginning on October 1, ~~1976~~, and ending on the date of the enactment of this subsection.

1985

* * * * * * *

SEC. 105. RENEGOTIATION PROCEEDINGS.

(a) PROCEEDINGS BEFORE THE BOARD.—Renegotiation proceedings shall be commenced by the mailing of notice, to that effect, in such form as may be prescribed by regulation, by registered mail or by certified mail to the contractor or subcontractor. The Board shall endeavor to make an agreement with the contractor or subcontractor with respect to the elimination of excessive profits received or accrued, and with respect to such other matters relating thereto as the Board deems advisable. Any such agreement, if made, may, with the consent of the contractor or subcontractor, also include provisions with respect to the elimination of excessive profits likely to be received or accrued. If the Board does not make an agreement with respect to the elimination of excessive profits received or accrued, it shall issue and enter an order determining the amount, if any, of such excessive profits, and forthwith give notice thereof by registered mail or by certified mail to the contractor or subcontractor. In the absence of the filing of a petition with the United States Claims Court under the provisions of and within the time limit prescribed in section 108, such order shall be final and conclusive and shall not be subject to review or redetermination by any court or other agency. The Board shall exercise its powers with respect to the aggregate of the amounts received or accrued during the fiscal year (or such other period as may be fixed by mutual agreement) by a contractor or subcontractor under contracts with the Departments and subcontracts, and not separately with respect to amounts received or accrued under separate contracts with the Departments or subcontracts, except that the Board may exercise such powers separately with respect to amounts received or accrued by the contractor or subcontractor under any one or more separate contracts with the Departments or subcontracts at the request of the contractor or subcontractor. *The Board shall renegotiate all contracts and subcontracts by division and by major product line within a division of the contractor or subcontractor.* By agreement with any contractor or subcontractor, and pursuant to regulations promulgated by it, the Board may in its discretion conduct renegotiation on a consolidated basis in order properly to reflect excessive profits of two or more related contractors or subcontractors. Renegotiation shall be conducted on a consolidated basis with a parent and its subsidiary corporations which constitute an affiliated group under section 141(d) of the Internal Revenue Code if all of the corporations included in such affiliated group request renegotiation on such basis and consent to such regulations as the Board shall prescribe with respect to (1) the determination and elimination of excessive profits of such affiliated group, and (2) the determination of the amount of the excessive profits of such affiliated group allocable, for the purposes of section 3806 of the Internal Revenue Code, to each corporation included in such affiliated group. Whenever the Board makes a determination with respect to the amount of excessive profits, and such determination is made by order, it shall, at the request of the contractor or subcontractor, as the case may be, prepare and furnish such contractor or subcontractor with a statement of such determination, of the facts used as a basis therefor, and of its reasons for such determinations. Such statement shall not be used in the United States Claims Court as proof of the facts or conclusions stated therein.

* * * * * * *

(f) MINIMUM AMOUNTS SUBJECT TO RENEGOTIATION.—

(1) IN GENERAL.—If the aggregate of the amounts received or accrued during a fiscal year (and on or after the applicable effective date specified in section 102(a)) by a contractor or subcontractor, and all persons under control of or controlling or under common control with the contractor or subcontractor, under contracts with the Departments and subcontracts described in section 103(g) (1) and (2), is not more than $250,000, in the case of a

fiscal year ending before June 30, 1953, or $500,000, in the case of a fiscal year ending on or after June 30, 1953, or $1,000,000, in the case of a fiscal year ending after June 30, 1956, *or $5,000,000 in the case of a fiscal year ending after the date of the enactment of the Renegotiation Act Amendments of 1985* the receipts or accruals from such contracts and subcontracts shall not, for such fiscal year, be renegotiated under this title. If the aggregate of such amounts received or accrued during the fiscal year under such contracts and subcontracts is more than $250,000, in the case of a fiscal year ending before June 30, 1953, or $500,000, in the case of a fiscal year ending on or after June 30, 1953, or $1,000,000, in the case of a fiscal year ending after June 30, 1956, *or $5,000,000 in the case of a fiscal year ending after the date of the enactment of the Renegotiation Act Amendments of 1985*, no determination of excessive profits to be eliminated for such year with respect to such contracts and subcontracts shall be in an amount greater than the amount by which such aggregate exceeds $250,000, in the case of a fiscal year ending before June 30, 1953, or $500,000, in the case of a fiscal year ending on or after June 30, 1953, or $1,000,000, in the case of a fiscal year ending after June 30, 1956, *or $5,000,000 in the case of a fiscal year ending after the date of the enactment of the Renegotiation Act Amendments of 1985*

* * * * * * *

(3) COMPUTATION.—In computing the aggregate of the amounts received or accrued during any fiscal year for the purposes of paragraph (1) of this subsection, there shall be eliminated all amounts received or accrued by a contractor or subcontractor from all persons under control of or controlling or under common control with the contractor or subcontractor and all amounts received or accrued by each such person from such contractor or subcontractor and from each other such person. If the fiscal year is a fractional part of twelve months, the $250,000 amount, the $500,000 amount, the $1,000,000 amount, *the $5,000,000 amount*, and the $25,000 amount shall be reduced to the same fractional part thereof for the purposes of paragraphs (1) and (2). In the case of a fiscal year beginning in 1950 and ending in 1951, the $250,000 amount and the $25,000 amount shall be reduced to an amount which bears the same ratio to $250,000 or $25,000, as the case may be, as the number of days in such fiscal year after December 31, 1950, bears to 365, but this sentence shall have no application if the contractor or subcontractor has made an agreement with the Board pursuant to section 102(c) for the application of the provisions of this title to receipts or accruals prior to January 1, 1951, during such fiscal year. In the case of a fiscal year beginning on or before the termination date and ending after the termination date the [$1,000,000] *$5,000,000* amount and the $25,000 amount shall be reduced to an amount which bears the same ratio to [$1,000,000] *$5,000,000* or $25,000, as the case may be, as the number of days in such fiscal year before the close of the termination date bears to 365.

* * * * * * *

Chairman **Hubbard**. Our witnesses include the following individuals: Eleanor R. Spector, Deputy Assistant Secretary of Defense for Procurement, U.S. Department of Defense; Paul F. Math, Associate Director, National Security and International Affairs Division, U.S. General Accounting Office; Richard F. Kaufman, General Counsel of the Joint Economic Committee; William R. Tolley, director, legislative affairs, Harris Corp.; Richard G. Mulligan, chairman, Committee on Government Business, Financial Executives Institute; and Donald S. Grenough, partner, Touche Ross & Co.

We look forward to receiving the testimony from our panels of witnesses.

Before you come before us, we would like to ask first for opening remarks by other members of our subcommittee.

First, Hon. Stan Parris, Congressman of Virginia, our ranking minority Member.

Mr. **Parris**. Thank you, Mr. Chairman.

Today's hearing is intended to address the issue of the necessity to reinstate the Renegotiation Act or as it is euphemistically called by H.R. 3020, the War Profiteering Prohibition Act.

Whatever name you give it, "a rose is still a rose is still a rose," and the Renegotiation Board is still a renegotiation board, a defunct, out of date, and unnecessary agency which has been found to cost more to the taxpayers than it has recovered from excessive profits.

The Renegotiation Board was established in 1951 by the Renegotiation Act, to capture excessive and unwarranted profits realized on defense contracts negotiated during wartime conditions. The life of the Board has been extended several times until Congress let the act expire in 1976, when it, in fact, concluded that the costs outweighed the profits recovered.

Furthermore, it was a burden on business in regard to the cost of compliance, and that of recordkeeping and reporting as well as a burden to the Department of Justice to prosecute the cases.

As the chairman just indicated in his remarks, the issue of reinstating the Board has come up over a dozen times since 1976, and I might emphasize, no Congress has reauthorized it.

But again today, we are faced with a question of whether we need it or whether the existing safeguards in the Federal defense contracting process, whether the Federal Government defense contracting processes are adequate to assure the effective management of the procurement system.

We currently have a number of auditing programs which have replaced the Renegotiation Board functions. These include the Defense Contract Audit Agency, the Truth in Negotiation Act, the Armed Services Procurement Regulations, and the Contract Profit Controls.

The process of reviewing defense contracts and recapturing excessive profits from the contractors makes little sense in peacetime when procurement officers and manufacturing firms have the time to efficiently and effectively evaluate the costs and profits of the goods and services needed by the Government. Further, Public Law 97-86 provides the President the powers to institute controls on excessive profits, on defense contracts upon or during declaration of war by Congress, or a declaration of a state of emergency by the President or by the Congress.

I would also like to note the focus of the Renegotiation Board was on controlling profits after the fact, not on controlling costs. Furthermore, in a time when Congress is attempting to reconcile budget deficits, I find it ironic that we establish yet another governmental agency that will only add to the Government's borrowing dilemma.

I have the highest possible regard for the gentleman from Texas, my friend, Mr. Gonzalez, who is the author of this bill and is its sponsor. I gather he has picked up the gauntlet carried for many years by Mr. Minish, former chairman of this subcommittee, who had a peculiar fondness for the Renegotiation Board.

Mr. **Gonzalez**. No—he picked up the gauntlet from me and now I am picking the gauntlet back up.

Mr. **Parris**. I am informed that Mr. Minish picked up Mr. Gonzalez' gauntlet and he has now reclaimed what was originally his. Don't confuse me with the facts. I don't mean to appear to say that my mind is made up. By the same token, I would suggest respectfully that the renegotiation idea has very few, if any, redeeming virtues, and these witnesses have a very large burden of proof to carry, at least for this member of this subcommittee of this Congress.

Thank you, Mr. Chairman.

Chairman **Hubbard**. Thank you very much, Congressman Parris. We thank you for that good statement.

A cartoon in the New York Times recently had two Members of Congress coming out of the Capitol and one said to the other, "We are going to have to reduce Federal spending soon, I am not sure what comes after a trillion."

Well, that cartoon came to mind when I misread one sentence in my remarks, being from a small town operating on a small budget, I am not used to saying the word "trillion" very often, but I should have said by way of background during President Reagan's first term Congress heeded his call to rearm the Nation by giving the Pentagon $1.1 trillion to spend, a 36-percent increase after inflation.

I said billion back there, I should have said trillion.

I am like the two Members in the cartoon, I am not sure what comes after a trillion.

Mr. **Barnard**. Disaster.

Chairman **Hubbard**. Disaster, right.

OK, so the House Committee on Armed Services chaired by Congressman Aspin has launched a series of hearings, asking what have we got for a trillion dollars.

Now, we call on the sponsor of the bill, the advocate of this Renegotiation Act and Board, our distinguished colleague from Texas, Congressman Henry B. Gonzalez.

Mr. **Gonzalez**. Thank you very much, Chairman Hubbard, first of all for being willing to assign a hearing date on this bill, H.R. 3020.

I am very grateful to you. We have not been that successful at times in the past and so I think the record ought to show that you are more than just interested, you are committed, to pursuing what

I consider to be an imperative, and one that should have been so considered all along.

I think that your staff has been outstanding, Ms. Fortney and Mr. Carter have been extremely helpful. They have extended every possible courtesy and consideration, so I wish to express my profound gratitude.

My interest in the Renegotiation Act extends 20 years at a point in time when the legislative jurisdiction of the act was in the Ways and Means Committee. At that time, there was the beginning of a strong, sustained movement to first hamstring and then to kill off the Renegotiation Board. In 1967 after 18 speeches during an off debate in special orders, we persuaded the Ways and Means Committee chairman then to hold up the demise of the Board. It was very difficult, because first very few of the members of the committee itself at that time, the Ways and Means Committee, even knew of the existence of the Renegotiation Board.

What I said was that what we would end up with would be pulling the teeth from the watchdog which in effect, that is what the Congress did. What we encountered was a self-fulfilling prophesy: First, legislative and budgetary constraints fell upon the Board, making it difficult to function; and then when the problems became evident, they were used as justification for still more restrictions. Finally, the Board expired at midnight at the end of a session around about 1978 or 1979. Despite the best efforts of myself at that time and by that time Chairman Minish of the subcommittee and a few others, who believed that it was the best policeman on the block, in fact the only real protection against defense contract profiteers.

The words sound harsh, but as Garrison said, the truth is harsh and justice is uncompromising.

Since the demise of the Renegotiation Board, the defense contracts have soared in volume to the point where now the Pentagon commits about $125 billion a year in new procurement contracts and where in 1967 we were talking about some 40 or 45 percent of the negotiated nonbid, today that nonbid, noncompetitive negotiated process involves over 80 percent, maybe perhaps better than 85 percent.

At the same time, the profitability of the defense contracting has grown immensely. Just how profitable defense contracting is no one can say for sure, but there is no doubt that these are great times in the boardrooms of arms suppliers.

Since the demise of the Renegotiation Board, there has also been a rapid increase in the number of horror stories about padded bills by defense contractors—ranging from phony labor charges to bills for taking care of executive dogs. There have likewise been horror stories about cost overruns for weapons that don't work, and stories about ordinary hand tools that somehow cost the Government hundreds of dollars apiece. You have to wonder: Is there a connection?

We are assured that there are plenty of ways to prevent profiteering and padded bills. Yet we read accounts of how the Defense Contract Audit Agency has problems even securing access to contractor records; how its auditors meet with continual frustration; and how their resources are hopelessly inadequate. It is revealing when a business journal like the Wall Street Journal calls the audit agency a toothless watchdog, which it was called in the Board after it was extracted of its teeth.

The fact is, there cannot be a perfect protection against defense contract overcharges. This is a fact of life; it is a problem that has plagued every army from George Washington's to George Patton's.

The question we face is this: If, despite all the protections and procedures that we will hear about this morning and as we have in the past, there is still egregious overcharging and excess profit, what can the Government do? If there is an excess profit accrued for some reason short of fraud or misinformation, what can the Government do to recover some of its money?

The Renegotiation Board could look into contracts, verify costs, and ensure that excess profits were recaptured. We have no such tool today. With the Pentagon signing up new contracts at the rate of $2 billion or so a week, it represents the richest treasure trove since the Comstock Lode. It makes the fortunes secured by the 49'ers pale by comparison. There is so much to be made in the defense business that the old-time oil barons look downright unambitious. With all the money that is at stake, there is no question that profiteering is a problem. The question is, What will we do about it?

Thank you, Mr. Chairman.

Chairman HUBBARD. Thank you, Congressman Gonzalez.

We will now call on Congressman Steve Bartlett of Texas.

Mr. BARTLETT. Thank you, Mr. Chairman.

Chairman HUBBARD. Thank you for being here with us this morning.

Mr. BARTLETT. Thank you very much.

I have a great deal of respect for the subcommittee chairman, Carroll Hubbard. I am not going to spend a lot of time as far as an opening statement talking about the Renegotiation Board, other than to comment that I have perhaps less of an open mind than my colleague, Stan Parris from Virginia, to such a discredited proposal.

It seems to me one of the best actions that the 1976 session of Congress took was their inaction or nonaction in deciding not to renew this Board. What I would suggest though is that because we have an array of rather impressive witnesses today thanks to the chairman of the Housing Subcommittee, my colleague from Texas and the chairman of the subcommittee, it would be useful to, once we get the testimony started and past the renegotiation idea, inquire of each of you as to what proposals you would make to what things the Congress or the Department of Defense could do better to solve the multiple and well-reported procurement difficulties we have had.

So I would say in advance so you will have time to think about it, that if you could offer some ideas on competitive bidding, on increasing the amount of competitive bidding, offer ideas on how to have additional, more fixed price bids to replace cost-plus bids, offer ideas on how to provide safeguards into the sole source contracting, offer ideas as to how and which of the myriad of congressional mandates ought to be removed which add to the cost, or ideas as to how to keep Congress from micromanaging everything in the Defense Department which adds so much to the cost, or other suggestions on engineering or over specifications which add to the cost and paperwork of the procurement process.

I suppose my question would be an open ended one of each of the witnesses—it is a twofold question, if you were in our shoes, what would be the most important action that you would recommend Congress take to increase the efficiency of the procurement process.

Second, if you could make a recommendation, a single recommendation to the Department of Defense concerning improving the procurement process, what would the single most important recommendation to the Department of Defense be?

I thank the chairman for the time.

Chairman HUBBARD. Thank you.

We will now call on our friend, Congressman Doug Barnard of Georgia, for his opening remarks.

Mr. BARNARD. Thank you, Mr. Chairman.

I have no opening remarks at this time, except to say that this is somewhat deja vu for this committee going back as long as I have been in the Congress.

The only thing I see missing is Admiral Rickover, and hopefully we will continue to miss him in this hearing.

But I would say, Mr. Chairman, I do think that it is a subject that we need to hear about from time to time. I think that we are all concerned whether we are on the Banking Committee or Armed Services Committee, Budget Committee or Ways and Means Committee, we are very much concerned about the cost of Government today, including defense.

We want to get the best deal possible for the dollars we are spending.

However, I would like to say at this time, that I think one of the most valuable assets we have in our country today are our defense contractors, the fact that they are willing to devote their energies and their institutions to the manufacturing. Certainly we are not going to federalize the defense industry in our country, it will not be run by the Federal Government, so I think we ought to give credit to the fact that we are as sufficient today militarily and defensively as we are because of the devotion and patriotism and dedication of our defense industry.

I am agast as all Members of Congress are, by these horror stories that develop from time to time, but the interesting thing about it is while the press gives great notoriety to these incidents, they are not the ones that uncover them. It is the Department of Defense that uncovers them. They are the ones, they are their own policemen in these matters.

While we certainly stand back in great distress when we see the exorbitant amounts spent for hammers, screwdrivers, and toilet seats, we should have some encouragement in the fact that these things are a part of the ongoing oversight of the agencies of our Government.

So I think it is worth while to review the subject again. I commend my friend, Congressman Gonzalez, to bringing it back to our attention and our distinguished chairman for having this, what I am sure will be a very interesting and informative hearing.

Mr. GONZALEZ. Will the gentleman yield?

Mr. BARNARD. Yes, sir.

Mr. GONZALEZ. I asked the gentleman to yield and I thank him for his yielding. I cannot remain silent without the record showing that there are some of us that feel grateful to Admiral Rickover. Everyone must realize that he had very serious shortcomings, but so do we all. But what he did overall, I think, in this respect and in his capacity as a negotiator on the Navy side of the table is on the record and it is undisputed. His appearances before the Congress did turn out to be acrimonious. Many times I took him to task for what I considered to be unjustifiable remarks, but I don't think that I can sit by idly and allow the name of Admiral Rickover to be depreciated in an unjustifiable way. I think the record ought to show that he did cooperate with the Congress and the committees in the best way he could do it, and I just thank the gentleman for yielding so I could put that in the record.

Mr. BARNARD. Well, I think that is very well put, and I think everybody in America honors Admiral Rickover for what he has meant in the area of defense and nuclear naval power. We all owe him a great debt of gratitude for all of those great things that he did.

We don't owe him a debt of gratitude for demeaning the reputation of Members of Congress which, as you know very well, he did before this committee. So that was the point I was making more than anything else.

I give back the balance of my time.

Chairman HUBBARD. Thank you, Congressman Barnard.

We will now call on our colleague and friend, Congressman Rod Chandler of the State of Washington.

Mr. CHANDLER. Well, Mr. Chairman, I have no statement. Thank you.

Chairman HUBBARD. We will call on Congressman Al McCandless of the State of California.

Mr. McCANDLESS. Thank you, Mr. Chairman.

I would like to express my appreciation to you and the ranking member for bringing this to our attention and for a process such as we are going through this morning. I would like to reiterate for those of you who will be testifying what my colleague, Mr. Bartlett, said about what we can do to improve the system.

I would just say briefly that in another life I was both the seller and the buyer of instruments to a tax-supported agency, and also part of the procurement as a tax-supported agency of items, and I realized the problems, and I understand the complexity of the situation, but I also would leave this thought with you: It is my feeling in doing some cursory investigation on these various and sundry items that have made headlines that it is the procurement process, the design process that we need to look at more than the profit process.

It is my understanding that this $6,000-plus coffeemaker that made headlines here a while back was designed in such a way that it was to provide a gravity force or operate under a gravity force greater than the airframe in which it was to travel. And so there was not a profit problem there; there was a design problem that neither the plane nor the pilot flying it would be able to stand the G gravity that this coffeemaker was designed to handle.

So, therein lies an oversimplification, possibly. But therein lies a major part of the problem.

It seems when the Federal or other levels of government get involved in the hammer, for example, they are not satisfied with the Stanley hammer with the standard claws that has a handle that is a certain length. Somebody has to go out and design a hammer that has claws just a little longer, a handle that has just a little bit more in the way of a design than the standard hammer; and as a result, they order 50,000 of these.

The people who make that bid or bid that item tend to design an entire plant to provide this hammer, which has a limited production; and as a result, sometimes, be it a hammer or screwdriver, if that is the case, it costs a great deal more money.

I am looking forward to the hearings, Mr. Chairman, and I think we can make some production out of it. I would like to ask those of you who are going to testify again to look at this from the point of view that Congressman Bartlett pointed out: What can we do to improve the system beyond that that we are already attempting to do?

Thank you, Mr. Chairman.

Chairman **Hubbard**. Thank you, Congressman McCandless.

I call on Congressman George Wortley, but I know he has already expressed the desire to move on to the witnesses and he will waive his opportunity of an opening statement.

We now call on Eleanor Spector and Paul Math to take seats at the witness table. Again, Eleanor Spector is the Deputy Assistant Secretary of Defense for Procurement of the Department of Defense. Paul Math is the Associate Director of the National Security and International Affairs Division of the U.S. General Accounting Office.

We welcome you both, and we will hear you both before we have any questions from our Members.

Eleanor, would you be heard first.

STATEMENT OF ELEANOR R. SPECTOR, DEPUTY ASSISTANT SECRETARY OF DEFENSE FOR PROCUREMENT, DEPARTMENT OF DEFENSE

Ms. **Spector**. Thank you, and I am happy to be here and discuss the revised Renegotiation Act.

I have a detailed statement for the record which I would like to summarize for you, after which I will certainly answer any questions that you have. I have with me representatives from DCAA, and Jack Kendig, who works in my office.

As you know, statutory renegotiation was first established during World War II. At that time, as Mr. Parris noted, defense contracts were awarded in large numbers without much time for contracting officers to perform a thorough cost analysis or bargain at arm's length. As a result, there was a need to recoup excessive profits that had arisen from these war contracts.

Statutory renegotiation was enacted again during the Korean conflict, and that was in 1951, and was subsequently carried forward into the peacetime environment—in fact, 13 other times—until it was allowed to expire in 1976.

Except for two items, the proposed War Profiteering Prohibition Act is identical to the expired Renegotiation Act. Those two areas are raising the threshold for contractor business from $1 million to $5 million and broadening renegotiable profits. The original act would have considered total contractor profits—the proposed act would go to product line by product line, division by division.

DOD is opposed to the proposed bill because we don't consider it to be cost-effective, particularly in view of other legislative and regulatory changes that we have adopted since 1951 and additional competition that we have been doing.

By the way, our competition statistics are—about 48 percent of our dollars are competed, and in excess of 65 percent of our actions are competed.

In addition, there are already conditions under statutes which have been designed to prevent wartime profiteering that Mr. Parris alluded to.

There has been a considerable amount of testimony offered in the past as to why the Renegotiation Act was not extended, and the major reason cited was that it was not cost-effective. In the last year of operation, 1978, it cost about $6 million to operate the Board. We don't know exactly how much the data gathering from the contractors cost, but it was estimated by the Board at that time that it was about $20,000 per contractor covered, which would be a total of about $100 million a year for the defense industry.

During its 26-year life, the Board made determinations of excessive profits totaling about $1.4 billion, most of which was done during the first 7 years—more than half of it. When adjusted for taxes, the $1.4 billion is reduced to $576 million over the 26 years.

In addition, the Board was finding it increasingly difficult to reach agreement on excess profits. Seventy-eight percent of the determinations in 1978 were not by agreement but by order, as opposed to a 26-year average of about 37 percent being by agreement with contractors.

Contractors were litigating more and more as a result of that, and these statistics that I have just read we graphed out by year, and I find it very helpful to see it graphically. I would like to insert those graphics for the record, if I may.

[The following charts were submitted by Ms. Spector for inclusion in the record:]

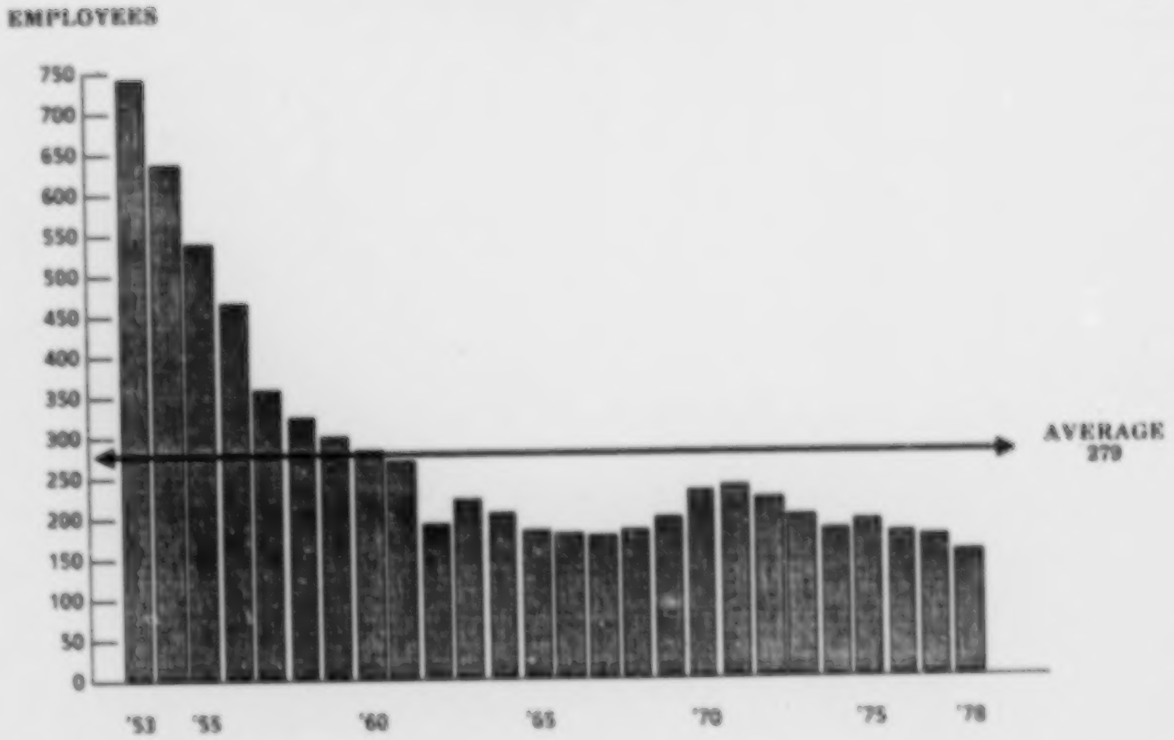
RENEGOTIATION BOARD

STATISTICAL ABSTRACT

1953 - 1978

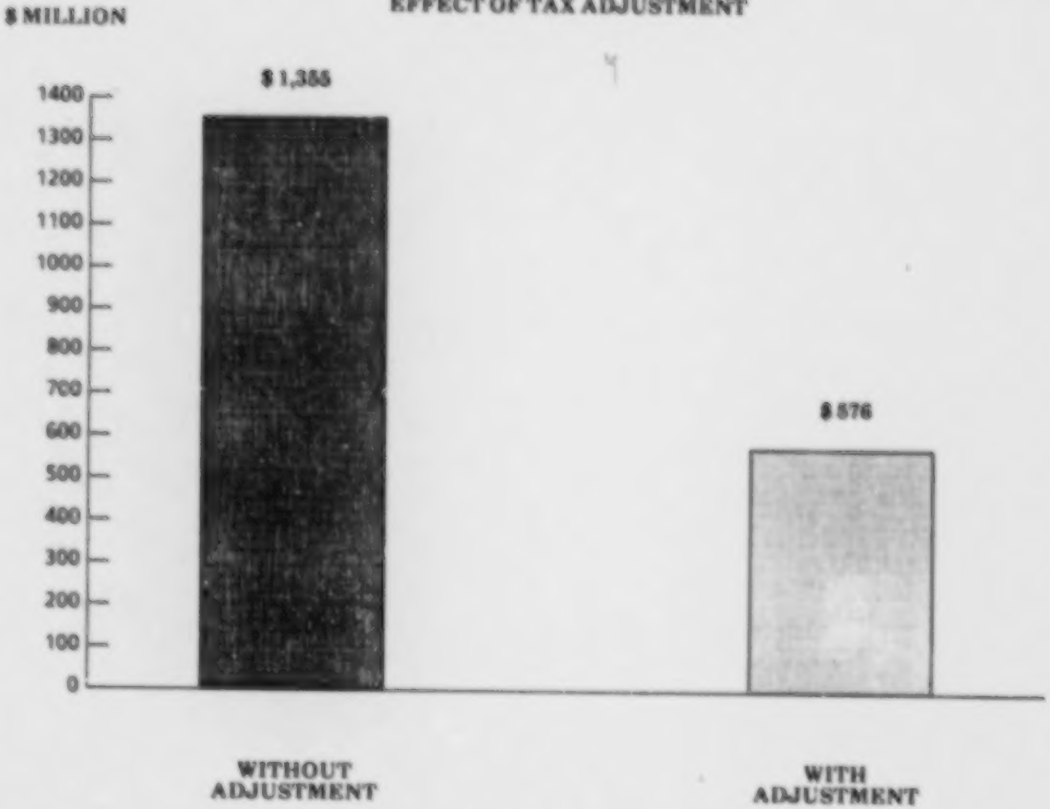
PREPARED BY : DIRECTORATE OF COST, PRICING, AND FINANCE
OFFICE OF DEPUTY ASSISTANT SECRETARY OF DEFENSE (PROCUREMENT)

RENEGOTIATION BOARD
NUMBER OF EMPLOYEES



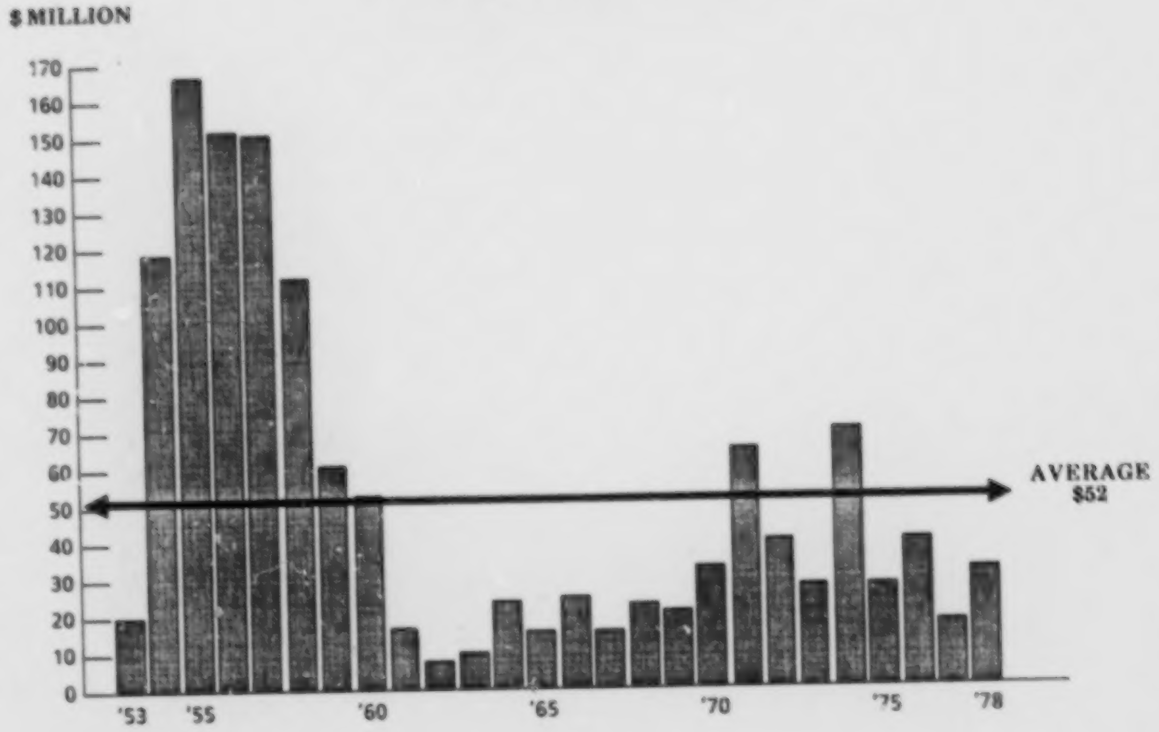
SOURCE: RENEGOTIATION BOARD ANNUAL REPORT FOR 1978

RENEGOTIATION BOARD
TOTAL DETERMINATIONS
EFFECT OF TAX ADJUSTMENT



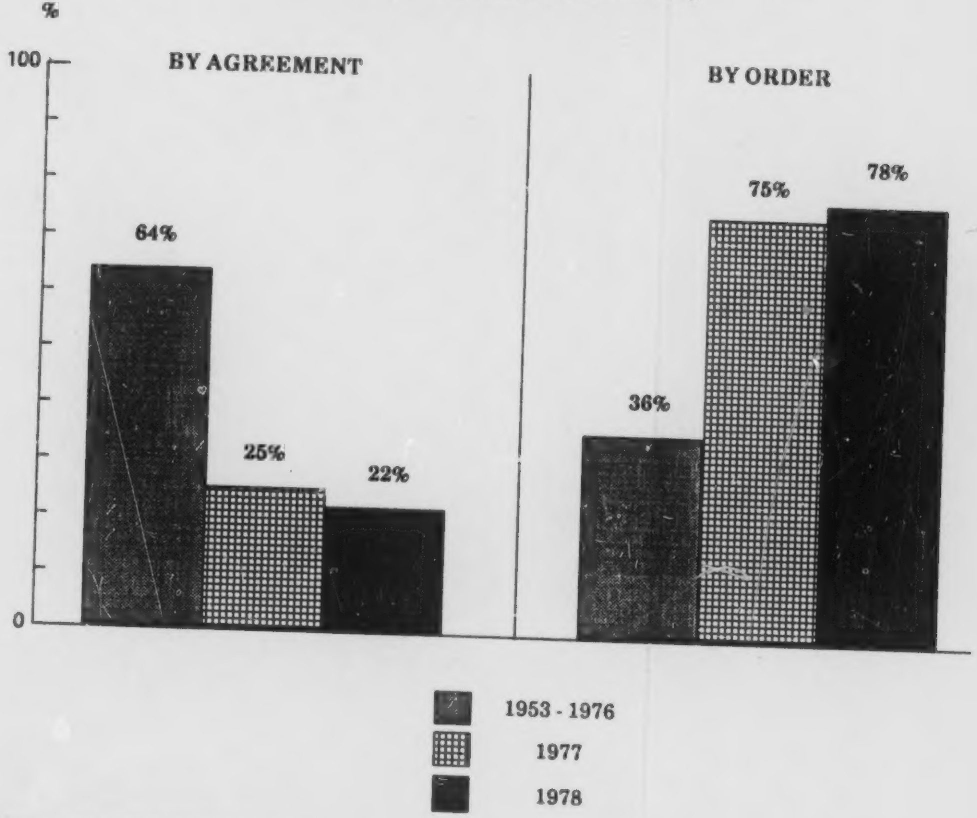
SOURCE: RENEGOTIATION BOARD ANNUAL REPORT FOR 1978

RENEGOTIATION BOARD
DETERMINATIONS BY DOLLAR VALUE
(BEFORE TAX ADJUSTMENT)



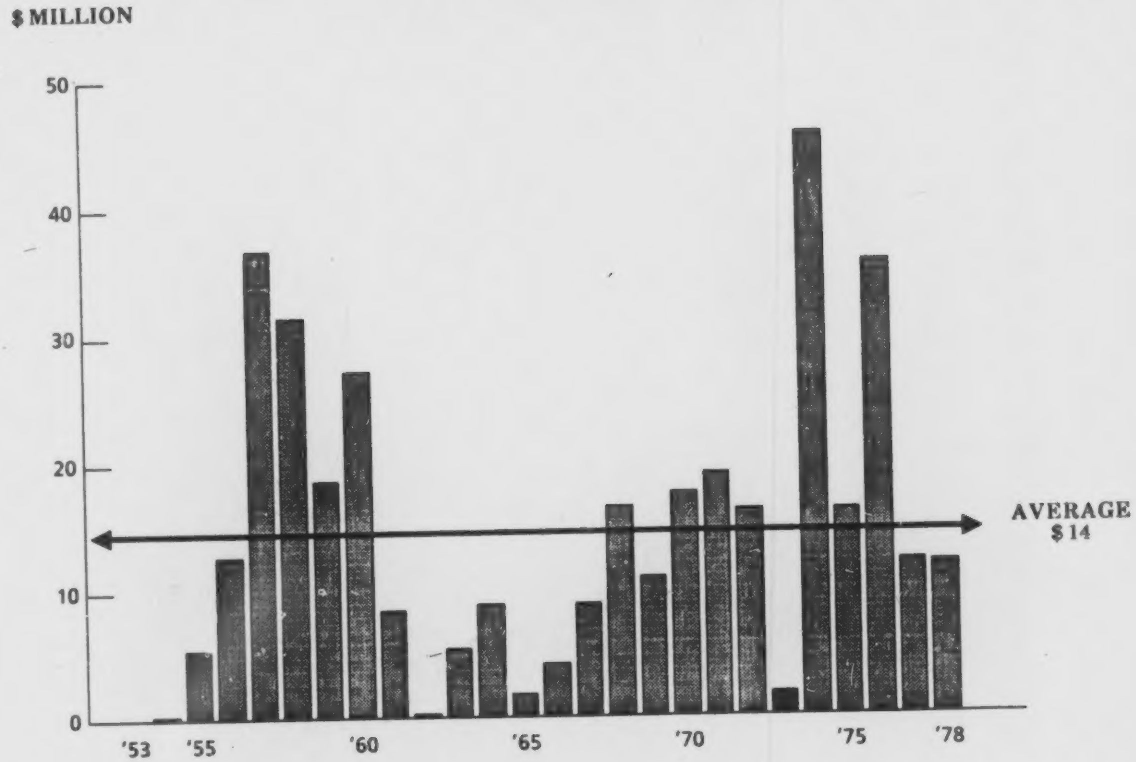
SOURCE: RENEGOTIATION BOARD ANNUAL REPORT FOR 1978

RENEGOTIATION BOARD
AGREEMENTS AND ORDERS BY DOLLAR VALUE
(BEFORE TAX ADJUSTMENT)



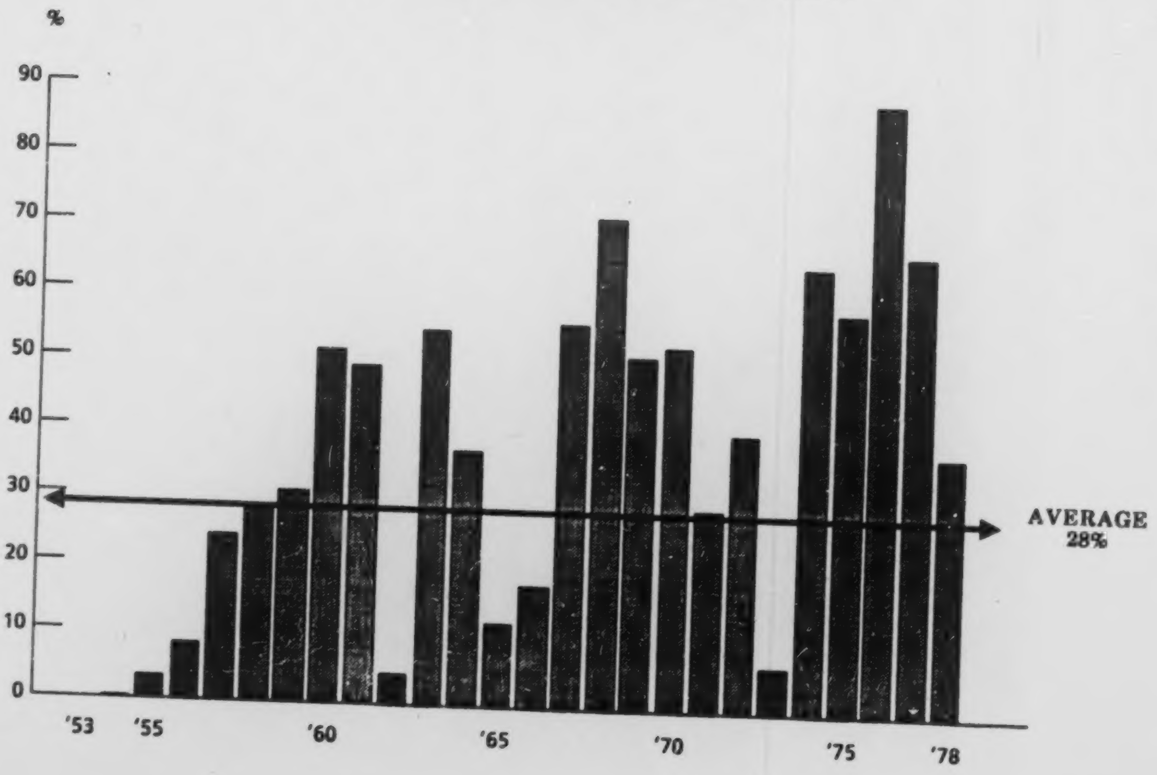
SOURCE: RENEGOTIATION BOARD ANNUAL REPORT FOR 1978

RENEGOTIATION BOARD
CONTRACTOR APPEALS BY DOLLAR VALUE



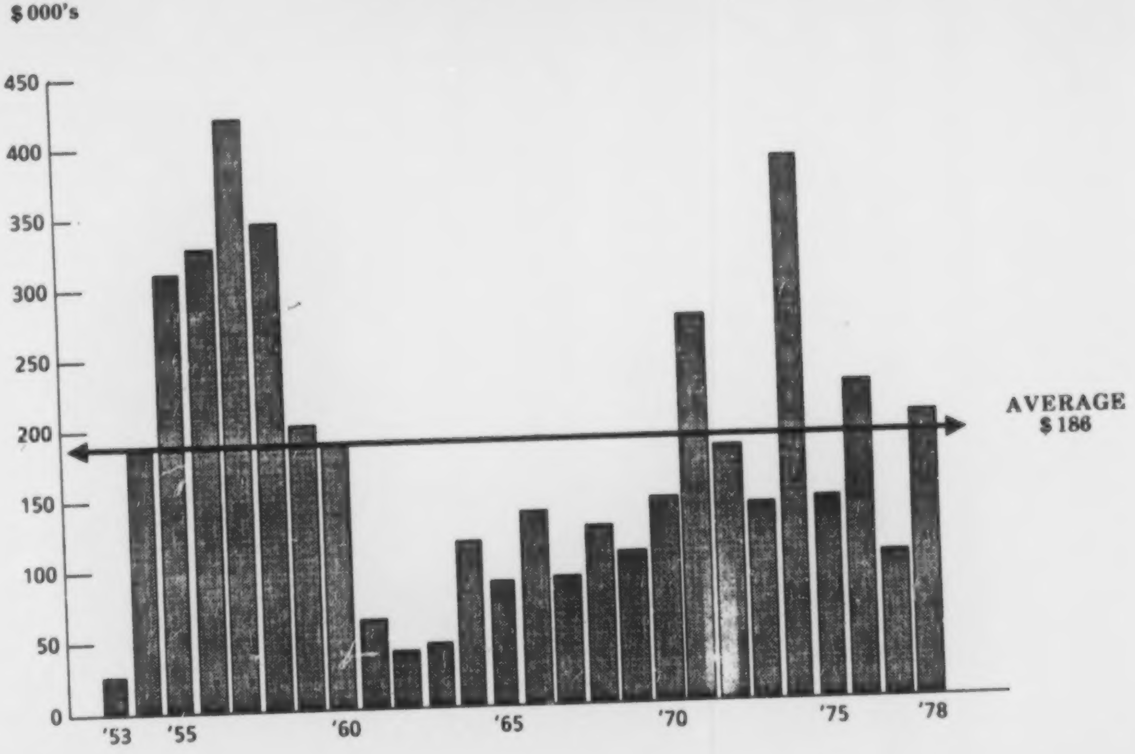
SOURCE: RENEGOTIATION BOARD ANNUAL REPORT FOR 1978

RENEGOTIATION BOARD
PERCENT APPEALED BY DOLLAR VALUE



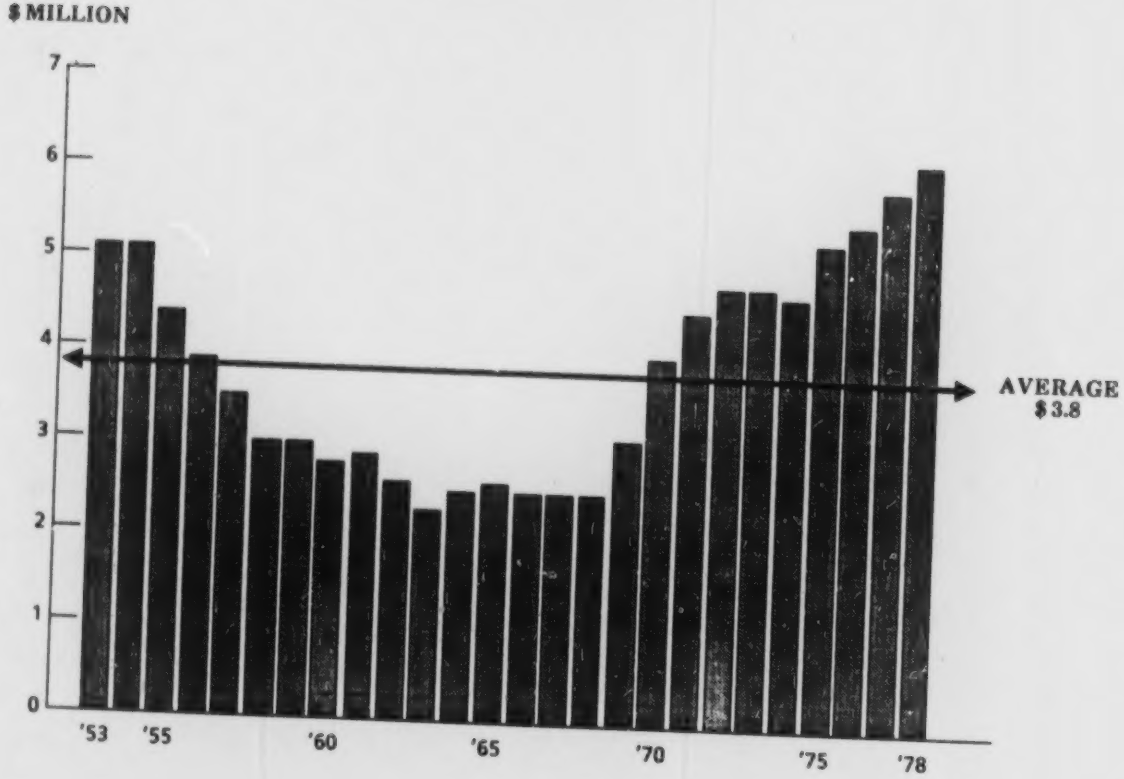
SOURCE: RENEGOTIATION BOARD ANNUAL REPORT FOR 1978

RENEGOTIATION BOARD
DETERMINATIONS PER EMPLOYEE
(BEFORE TAX ADJUSTMENT)



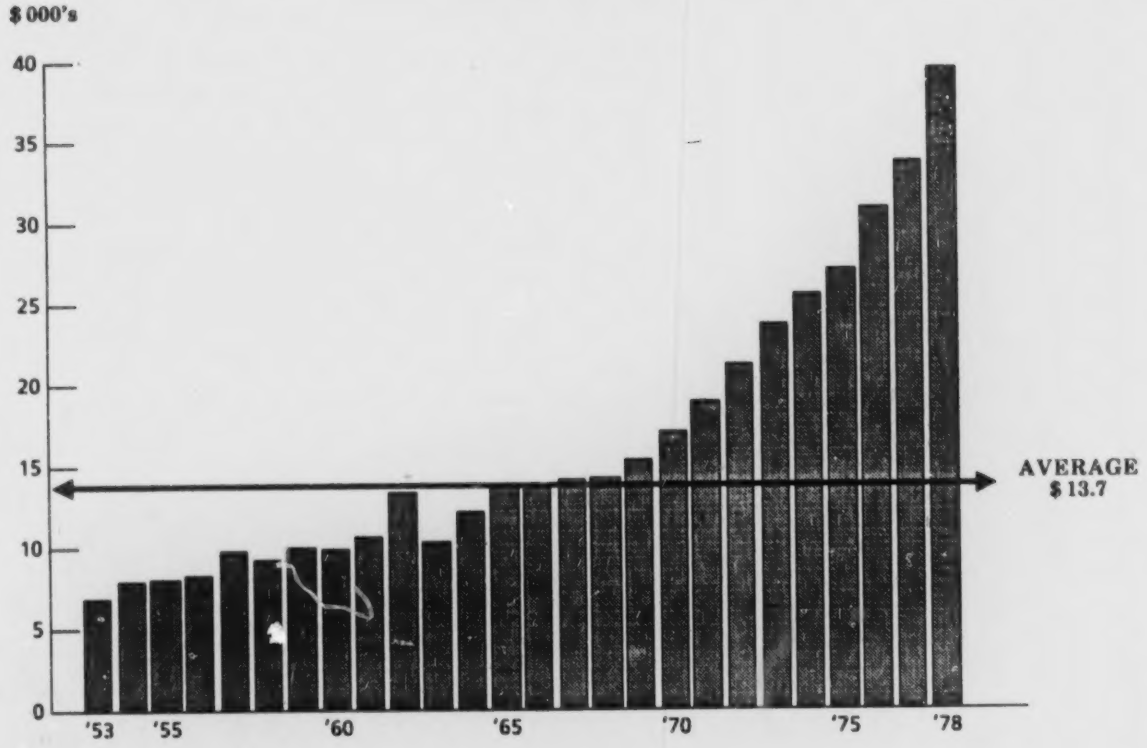
SOURCE: RENEGOTIATION BOARD ANNUAL REPORT FOR 1978

RENEGOTIATION BOARD
TOTAL OPERATING COSTS



'SOURCE: RENEGOTIATION BOARD ANNUAL REPORT FOR 1978

RENEGOTIATION BOARD
OPERATING COST PER EMPLOYEE



SOURCE: RENEGOTIATION BOARD ANNUAL REPORT FOR 1978

Ms. SPECTOR. The Renegotiation Act also dealt with symptoms. Other regulations and legislation has better dealt with causes. The most significant of that legislation was the Truth in Negotiations Act. This attempted to place the contracting officer and contractor on equal footing as far as the cost and pricing data available to each. The contractor had to certify that his pricing data was current, accurate, and complete.

We also have the right, the unilateral right, to adjust a contract price downward if the cost or pricing data is subsequently determined to be defective. And the DCAA performs audits to assure there is truth in negotiations.

In 1970, Congress created the Cost Accounting Standards Board. During its operation, 19 standards were issued to assure accurate, consistent, and equitable charging of costs to defense contracts. If a contractor is found to be in noncompliance, we have the unilateral right to price adjustments. We still comply with those standards, although the Board is no longer in existence.

In 1978, Congress passed the Inspector General Act within the Department of Defense. The inspector general has a staff of professionals who regularly perform audits and inspections in many areas, including procurement. And, as Mr. Barnard said, we are policing ourselves. This is the group that heavily does policing and has come up with many of these spares problems. Even though it is a relatively new function, the inspector general has made substantial contributions already to our finding areas of problems.

In addition to these legislative actions, there have been regulatory changes which have greatly reduced the potential for excess profits. In 1964, we adopted what is called a weighted guidelines method that is a uniform approach for establishing going-in profit objectives. It requires use of a standard form for analyzing profit on an element-by-element basis, which takes into account contractor technical risk, cost risk and amount of facilities capital employed. It provides a greater degree of control over profits.

A separate audit agency was established in 1965, and auditors are heavily involved in all facets of contract pricing and are the principal advisers to the contracting officer in financial areas. The auditor has a large role in assuring contract prices are fair and reasonable. The audit strength has increased 30 percent in the past 3 years, and we estimate another 220 auditors for 1986.

We established a cost monitor and review program in 1978. This is a formal Government program required at most contractor locations. We perform cost monitoring and reviews to identify contractor inefficiencies and, if warranted, to give notice of intent to disallow costs.

There was another point mentioned, that we ought to increase fixed price type contracts. A not widely known fact is that 80 percent of our contracts are fixed price; only 20 percent are cost type.

Statutory renegotiation appeals to some because it is supposed to create a structure which gives the public confidence that excess profits are not being paid to defense contractors, and that we would be able to take back whatever profits were deemed excessive, not just on an aggregate fiscal year basis, as under the Renegotiation Act of 1951.

H.R. 3020 would allow determinations to be made on a division-by-division, product-by-product basis. High profits on one product could not be netted against lower profits on another product. This is a change in the new bill. And although there may be some appeal from an appearance standpoint, there are other considerations that argue against the Renegotiation Act.

First, with all the dollars that are out there for defense—and you have mentioned those high dollar amounts, millions and trillions—are there really excess profits? A recent study we performed called DFAIR [Defense Finance and Investment Review] concluded, and I quote:

> Our current contract pricing, financing and markup policies are balanced, are protecting the interests of taxpayers and enabling U.S. industry to achieve an equitable return for their involvement in defense business.

We have submitted a copy of this study to you. I think it was quite a thorough and well-done study.

Second, we have a major question on fairness of division-by-division and product-by-product application of excess profit determinations. It is a fundamental business concept to diversify product lines in order to spread risk. A national policy for not allowing losses or low profits incurred on one defense contract to be netted against profits on another may work against the public interest. It would certainly have the potential of affecting a contractor's motivation to control costs, and it may affect other aspects of contract performance such as delivery schedules, quality, capital investment, to the extent that improvement in those areas would reduce costs and could result in higher profits.

Finally, there is a question of the marginal benefit of statutory renegotiation over its marginal cost. Current controls enacted by Congress and others that we have adopted, we believe are controlling excess profits.

In summary, we oppose H.R. 3020 for the same reason Congress did not extend the act in 1976: It is not cost effective. The services and DCAA concur in this position.

This concludes my comments. I will be happy to respond to any questions you may have.

[The prepared statement of Ms. Spector follows:]

STATEMENT
OF

ELEANOR R. SPECTOR

DEPUTY ASSISTANT SECRETARY OF DEFENSE FOR PROCUREMENT

ON

H. R. 3020

WAR PROFITEERING PROHIBITION ACT OF 1985

BEFORE THE

SUBCOMMITTEE ON GENERAL OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

OCTOBER 30, 1985

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SUBCOMMITTEE

GOOD MORNING, MR. CHAIRMAN AND SUBCOMMITTEE MEMBERS. I WELCOME THE OPPORTUNITY TO APPEAR BEFORE YOU AND DISCUSS OUR VIEWS ON THE NEED TO REVISE AND REINSTATE THE RENEGOTIATION ACT OF 1951. I AM WELL AWARE OF THE HARD WORK THIS COMMITTEE HAS DEVOTED OVER THE YEARS TO THIS IMPORTANT SUBJECT

LEGISLATIVE HISTORY

AS YOU KNOW, STATUTORY RENEGOTIATION WHICH GIVES THE GOVERNMENT THE AUTHORITY TO RECOUP EXCESSIVE PROFITS FROM DEFENSE CONTRACTORS WAS FIRST ESTABLISHED DURING WORLD WAR II AS THE RENEGOTIATION ACT OF 1942. THE WAR CREATED AN ENVIRONMENT WHERE DEFENSE CONTRACTS WERE AWARDED IN LARGE NUMBERS WITHOUT MUCH TIME FOR CONTRACTING OFFICERS TO PERFORM A THOROUGH COST ANALYSIS AND BARGAIN AT ARMS-LENGTH WITH DEFENSE CONTRACTORS. THERE WAS NO COMPETITIVE MARKET PLACE WHICH WOULD CONTROL PRICES. AS A RESULT, THERE WAS A COMPELLING NEED TO HAVE SOME METHOD FOR RECOUPING EXCESSIVE PROFITS THAT HAD BEEN RECEIVED BY CONTRACTORS. STATUTORY RENEGOTIATION WAS LIKEWISE ENACTED DURING THE KOREAN CONFLICT AND BECAME KNOWN AS THE RENEGOTIATION ACT OF 1951. THE CONCEPT OF STATUTORY RENEGOTIATION WAS LATER APPLIED TO THE PEACETIME BUSINESS ENVIRONMENT. THE RENEGOTIATION ACT OF 1951 WAS EXTENDED BY CONGRESS 13 TIMES, BUT ULTIMATELY IT WAS ALLOWED TO EXPIRE ON SEPTEMBER 30, 1976. THE OPERATIONS OF THE RENEGOTIATION BOARD, CREATED UNDER THE 1951 ACT, WERE TERMINATED IN 1979.

THE RENEGOTIATION BOARD

THE RENEGOTIATION ACT REQUIRED A CONTRACTOR WITH REQUISITE "RENEGOTIABLE SALES" TO SUBMIT ANNUAL REPORTS TO THE RENEGOTIATION BOARD. THE BOARD THEN ASSESSED THE CONTRACTOR'S AGGREGATE PROFIT, USING SEVERAL QUANTITATIVE AND QUALITATIVE FACTORS. A DETERMINATION OF EXCESSIVE PROFITS WAS MADE USING ONE OF TWO METHODS: BY AGREEMENT OR BY ORDER. THE BOARD'S OBJECTIVE WAS TO REACH AGREEMENT WITH THE CONTRACTOR ON EXCESSIVE PROFITS. WHEN BY ORDER DETERMINATIONS WERE NECESSARY, THE CONTRACTOR COULD OBTAIN A REDETERMINATION BY FILING A PETITION TO THE UNITED STATES TAX COURT. IN 1971, JURISDICTION WAS TRANSFERRED TO THE UNITED STATES COURT OF CLAIMS.

THERE HAS BEEN A CONSIDERABLE AMOUNT OF TESTIMONY OFFERED IN THE PAST AS TO WHY THE RENEGOTIATION ACT OF 1951 WAS NOT EXTENDED BY CONGRESS IN 1976 AND WHY THE BOARD WAS TERMINATED IN 1979. THE MAJOR REASON CITED WAS THAT THE ACT HAD CEASED TO BE COST EFFECTIVE. THE BOARD'S 23RD REPORT TO CONGRESS ON OCTOBER 16, 1978, SHOWED THAT THE BOARD COST ROUGHLY $6 MILLION DOLLARS A YEAR TO OPERATE. THE COSTS TO THE DEFENSE INDUSTRY TO MAINTAIN THE NECESSARY ACCOUNTING RECORDS, TO SUBMIT FINANCIAL REPORTS TO THE BOARD, TO RESPOND TO INQUIRIES OF THE BOARD, AND TO PROCESS APPEALS WERE NOT PRECISELY KNOWN BUT WERE BELIEVED TO BE HIGH. IN TESTIMONY IN 1981 BEFORE THE PROCUREMENT AND MILITARY NUCLEAR SYSTEMS SUBCOMMITTEE, HOUSE OF REPRESENTATIVES COMMITTEE ON ARMED SERVICES, THE FORMER DIRECTOR OF OPERATIONS OF THE RENEGOTIATION BOARD ESTIMATED SUCH COSTS TO BE $20,000 PER YEAR FOR EACH AFFECTED COMPANY. HE EQUATED THIS TO $100 MILLION FOR THE DEFENSE INDUSTRY ANNUALLY.

DURING ITS 26 YEAR LIFE, THE BOARD MADE DETERMINATIONS OF EXCESSIVE PROFITS TOTALLING $1.4 BILLION, MORE THAN HALF OF WHICH WAS MADE DURING THE BOARD'S FIRST 7 YEARS (1953 TO 1959). THE $1.4 BILLION DID NOT INCLUDE DEDUCTION FOR FEDERAL INCOME AND EXCESS PROFITS TAXES. ACCORDING TO THE BOARD'S 1978 ANNUAL REPORT, AFTER THESE DEDUCTIONS THE NET DETERMINATIONS FOR THE 26 YEARS WAS $576 MILLION. PRIOR TESTIMONY ALSO REVEALED THAT THE NUMBER OF "BY ORDER" DETERMINATIONS HAD INCREASED IN PROPORTION TO THE "BY AGREEMENT" DETERMINATIONS. FOR EXAMPLE, BY DOLLAR VALUE, 78% OF THE DETERMINATIONS IN 1978 WERE "BY ORDER," AS OPPOSED TO A 26 YEAR AVERAGE OF 37%. FINALLY, THE PERCENTAGE OF REDETERMINATIONS SOUGHT BY THE CONTRACTORS ROSE AND THE RATE OF RENEGOTIATION BOARD DETERMINATIONS SUSTAINED BY THE COURTS FELL. THE REASON GIVEN FOR THE LOW SUSTENSION RATE WAS THE TRANSFER IN JURISDICTION OVER APPEALS FROM THE UNITED STATES TAX COURT TO THE UNITED STATES COURT OF CLAIMS. THIS WAS SEEN TO HAVE RESULTED IN A SHIFT IN THE BURDEN OF PROOF FROM THE CONTRACTOR TO THE GOVERNMENT.

CURRENT LEGISLATIVE AND REGULATORY CONTROLS

WHERE THE RENEGOTIATION ACT OF 1951 DEALT WITH SYMPTOMS, OTHER ACTIONS SINCE HAVE DEALT WITH THE CAUSES. LET ME REVIEW A FEW OF THE MAJOR ONES:

LEGISLATIVE ACTIONS

PUBLIC LAW 87-653. "TRUTH IN NEGOTIATIONS ACT" (1962)

THIS ATTEMPTED TO PLACE THE CONTRACTING OFFICER AND THE CONTRACTOR ON AN EQUAL FOOTING IN NEGOTIATING CONTRACT PRICE. THE ACT REQUIRES PRIME CONTRACTORS AND SUBCONTRACTORS TO SUBMIT COST OR PRICING DATA TO THE CONTRACTING OFFICER THAT IS CERTIFIED TO BE CURRENT, ACCURATE, AND COMPLETE PRIOR TO THE AWARD OF CERTAIN NEGOTIATED CONTRACTS EXPECTED TO EXCEED $100,000. THE ACT ALSO PROVIDES THE CONTRACTING OFFICER THE UNILATERAL RIGHT TO ADJUST A CONTRACT PRICE DOWNWARD IF THE COST OR PRICING DATA SUBMITTED BY THE CONTRACTOR IS SUBSEQUENTLY DETERMINED TO BE DEFECTIVE. THE DEFENSE CONTRACT AUDIT AGENCY REGULARLY PERFORMS DEFECTIVE PRICING AUDITS IN ORDER TO ASSURE THAT THERE WAS "TRUTH IN NEGOTIATIONS." IT SHOULD BE RECOGNIZED THAT THE SUBMISSION OF DEFECTIVE COST OR PRICING DATA CAN BE A PRIME CAUSE OF EXCESSIVE PROFIT. THAT IS, IF NEGOTIATED COSTS ARE ARTIFICIALLY HIGH BECAUSE OF INACCURATE COST OR PRICING DATA, THIS CAN RESULT IN AN UNDERRUN WHICH PRODUCES A HIGHER PROFIT. OUR IMPLEMENTATION OF THE ACT COVERS THE ENTIRE CONTRACTING SPECTRUM FROM PRE-PROPOSAL EFFORT THROUGH THE PERIOD AFTER CONTRACT AWARD. THESE AREAS ARE BRIEFLY ADDRESSED BELOW IN ORDER TO PROVIDE A BETTER UNDERSTANDING OF BOTH THE IMPLEMENTATION OF THE ACT AND THE PROTECTION THE ACT PROVIDES.

PRE-PROPOSAL EFFORT

PRIOR TO REQUESTING A PRICE PROPOSAL FROM A CONTRACTOR, THE CONTRACTING OFFICER PREPARES A DOCUMENT TITLED "REQUEST FOR PROPOSALS." DETAILED INSTRUCTIONS ON THE PREPARATION OF THIS DOCUMENT ARE INCLUDED IN OUR REGULATIONS. THESE INSTRUCTIONS TO THE CONTRACTING OFFICER PROVIDE GUIDANCE TO INSURE THAT ANY SUBSEQUENT CONTRACT COMPLIES WITH ALL APPLICABLE LAWS AND REGULATIONS. FOR EXAMPLE, WITH RESPECT TO P.L. 87-653 THE REQUEST FOR PROPOSAL WILL INCLUDE A DESCRIPTION OF ANY INFORMATION REQUIRED FROM THE OFFEROR TO SUPPORT PROPOSED PRICES. IT WILL NOTIFY THE OFFEROR OF THE REQUIREMENT THAT COST OR PRICING DATA MUST BE CERTIFIED AND IDENTIFY CONTRACT CLAUSES; SUCH AS, PRICE REDUCTION FOR DEFECTIVE PRICING AND THE AUDIT BY DEPARTMENT OF DEFENSE CLAUSE.

PROPOSAL EVALUATION EFFORT

AFTER RECEIPT OF THE CONTRACTOR'S PROPOSAL, THE CONTRACTING OFFICER INITIATES THE PROPOSAL EVALUATION PROCESS. THE BASIC POLICY OF THE DOD IS TO PROCURE SUPPLIES AND SERVICES FROM RESPONSIVE AND RESPONSIBLE SOURCES AT FAIR AND REASONABLE PRICES CALCULATED TO RESULT IN THE LOWEST OVERALL COST TO THE GOVERNMENT. TO ACHIEVE THIS OBJECTIVE, THE CONTRACTING OFFICER MUST ADHERE TO OUR POLICIES AND PROCEDURES WHICH ARE DESIGNED TO PROVIDE THE FRAMEWORK FOR A COMPREHENSIVE EVALUATION OF THE CONTRACTOR'S PROPOSAL. PRIOR TO NEGOTIATION OF A CONTRACT OR MODIFICATION

RESULTING FROM A PROPOSAL IN EXCESS OF $100,000, WHEN THE PRICE IS BASED ON COST OR PRICING DATA SUBMITTED BY THE CONTRACTOR, THE CONTRACTING OFFICER SHALL REQUEST AN ADVISORY FIELD PRICING REPORT. THE FIELD PRICING REPORT WILL INCLUDE BOTH A DCAA AUDIT REPORT ON THE COST AND FINANCIAL ASPECTS OF THE PROPOSAL, AND AN ENGINEERING EVALUATION REPORT COVERING THE QUANTITATIVE FACTORS IN THE PROPOSAL: SUCH AS, THE NEED FOR THE QUANTITIES AND SKILL MIX OF LABOR HOURS, TYPES AND QUANTITIES OF MATERIALS, NEED FOR COMPUTER TIME, ETC.

IF THE PROPOSAL IS LESS THAN $100,000 THE CONTRACTING OFFICER HAS THE OPTION OF REQUESTING A FIELD PRICING REPORT OR PERFORMING THE REQUIRED ANALYSIS HIMSELF. UNDER EITHER SCENARIO, THE CONTRACTING OFFICER IS RESPONSIBLE TO ASSURE THAT A PROPER ANALYSIS OF THE CONTRACTOR'S PROPOSAL HAS BEEN ACCOMPLISHED.

CONTRACT NEGOTIATION PHASE

THE PRICE NEGOTIATION PHASE OF THE PROCUREMENT CYCLE IS GENERALLY THOUGHT TO INCLUDE ESTABLISHING THE PRICE OBJECTIVE, OBTAINING MANAGEMENT APPROVAL OF THE PRICE OBJECTIVE, RESOLVING DIFFERENCES OVER SUBSTANTIAL QUESTIONED OR UNRESOLVED COSTS IN THE AUDIT REPORT, CONDUCTING THE NEGOTIATION CONFERENCE, REACHING AGREEMENT ON PRICE, OBTAINING A CERTIFICATE OF CURRENT COST OR PRICING DATA, AND PREPARING A RECORD OF THE NEGOTIATIONS.

ONCE THE PCO ESTABLISHES THE PRICE NEGOTIATION OBJECTIVE, SOUND BUSINESS PRACTICE REQUIRES THAT THE CONTRACTING OFFICER

OBTAIN APPROVAL OF THIS OBJECTIVE FROM MANAGEMENT. THIS STEP IS CONDUCTED SO THAT MANAGEMENT CAN BE ASSURED THAT THE CONTRACTING OFFICER HAS DONE A THOROUGH JOB OF SECURING AND EVALUATING COST OR PRICING DATA IN SUPPORT OF THE CONTRACTOR'S PROPOSAL AND IS ENTERING INTO NEGOTIATION WITH A WELL-CONCEIVED, REALISTIC AND FAIR PLAN.

WHEN THE CONTRACT PRICE IS AGREED TO BY THE PARTIES, THE CONTRACTING OFFICER REQUIRES THE CONTRACTOR TO CERTIFY THAT THE COST OR PRICING DATA SUBMITTED ARE ACCURATE, COMPLETE AND CURRENT.

AT THE CONCLUSION OF EACH NEGOTIATION, THE CONTRACTING OFFICER PREPARES A PRICE NEGOTIATION MEMORANDUM. THIS RECORD OF NEGOTIATIONS SETS FORTH THE PRINCIPAL ELEMENTS OF THE PRICE NEGOTIATION FOR INCLUSION IN THE CONTRACT FILE AND FOR THE USE OF ANY REVIEWING AUTHORITIES. THIS MEMORANDUM IS PREPARED IN SUFFICIENT DETAIL TO REFLECT THE MOST SIGNIFICANT CONSIDERATIONS CONTROLLING THE ESTABLISHMENT OF THE CONTRACT PRICE. A COPY OF THIS MEMORANDUM IS PROVIDED TO THE COGNIZANT ACO AND AUDITOR.

POST AWARD PHASE

NEXT IS THE POST-AWARD PHASE WHICH INCLUDES THE GOVERNMENT'S REMEDY IN THE EVENT IT FOUND THAT COST OR PRICING DATA WAS NOT ACCURATE, COMPLETE AND CURRENT AS STIPULATED BY THE CERTIFICATE OF CURRENT COST OR PRICING DATA. IF CERTIFIED COST OR PRICING DATA ARE SUBSEQUENTLY FOUND TO HAVE BEEN INACCURATE, INCOMPLETE OR

NONCURRENT AS OF THE EFFECTIVE DATE OF THE CERTIFICATE, THE GOVERNMENT IS ENTITLED TO AN ADJUSTMENT OF THE NEGOTIATED PRICE, INCLUDING PROFIT OR FEE, TO EXCLUDE ANY SIGNIFICANT SUM BY WHICH THE PRICE WAS INCREASED BECAUSE OF THE GOVERNMENT'S RELIANCE IN NEGOTIATIONS ON THE DEFECTIVE DATA.

WE RELY PRIMARILY ON THE DEFENSE CONTRACT AUDIT AGENCY (DCAA) TO AUDIT CONTRACTS SUBJECT TO THE TRUTH IN NEGOTIATIONS ACT FOR THE PURPOSE OF DETERMINING IF THE GOVERNMENT IS ENTITLED TO A PRICE ADJUSTMENT UNDER THE ACT. DCAA, THROUGH ITS REGULARLY SCHEDULED AUDIT PLAN, AUDITS THESE CONTRACTS AND ISSUES AUDIT REPORTS TO THE CONTRACTING OFFICERS WHERE DEFECTIVE PRICING IS INDICATED.

WHEN THE CONTRACTING OFFICER CONCLUDES THAT DEFECTIVE PRICING EXISTS, A CONTRACT PRICE ADJUSTMENT IN THE AMOUNT BY WHICH THE DEFECTIVE DATA CAUSED AN INCREASE TO THE CONTRACT PRICE IS REQUESTED OF THE CONTRACTOR. IF THIS IS NOT ACCEPTED BY THE CONTRACTOR, THE CONTRACTOR MAY FURNISH ADDITIONAL INFORMATION THAT MAY NOT HAVE BEEN AVAILABLE TO THE CONTRACTING OFFICER IN REACHING HIS POSITION ON THE ADJUSTMENT FOR DEFECTIVE PRICING. UTILIZING ALL AVAILABLE INFORMATION, THE CONTRACTING OFFICER WILL NORMALLY ATTEMPT TO NEGOTIATE A FAIR AND EQUITABLE SETTLEMENT WITH THE CONTRACTOR. AS IS THE CASE WITH MANY TYPES OF DISAGREEMENTS BETWEEN TWO PARTIES, THE UNDERLYING FACTS ARE NOT ALWAYS CLEARLY TO THE ADVANTAGE OF EITHER PARTY. IF THE PARTIES ARE UNABLE TO ARRIVE AT A MUTUALLY SATISFACTORY SETTLEMENT, THE CONTRACTING OFFICER WILL ISSUE A FINAL DECISION ON THE CASE. THE CONTRACTOR

THEN HAS THE OPTION OF ACCEDING TO THE FINAL DECISION OF THE CONTRACTING OFFICER OR IT MAY APPEAL THE DECISION TO THE ARMED SERVICES BOARD OF CONTRACT APPEALS OR FILE A SUIT AS PROVIDED BY THE CONTRACT DISPUTES ACT OF 1978 (P.L. 95-563). ISSUANCE OF A FINAL DECISION WITH THE POSSIBILITY OF SUBSEQUENT LITIGATION IS SOMETHING THAT IS NOT DONE IN DOD WITHOUT CAREFUL ANALYSIS AND LEGAL COUNSEL. WE RELY VERY HEAVILY ON OUR LEGAL COUNSEL THROUGHOUT THIS ENTIRE PROCESS. OFTEN TIMES, COUNSEL ADVISES THE PCO THAT IT WOULD BE IN THE BEST INTERESTS OF THE GOVERNMENT TO NEGOTIATE A SETTLEMENT RATHER THAN HAVING TO LITIGATE THE ISSUE DUE TO THE FACTS AND CIRCUMSTANCES INVOLVED IN THE CASE.

ONCE THE DEFECTIVE PRICING CASE IS SETTLED OUR REGULATION REQUIRES THE CONTRACTING OFFICER TO PREPARE A MEMORANDUM ON THE AUDIT REPORT INDICATING HOW THE ISSUE WAS RESOLVED. A COPY OF THIS MEMORANDUM IS FORWARDED TO THE AUDITOR ISSUING THE AUDIT REPORT AND TO THE COGNIZANT ADMINISTRATIVE CONTRACTING OFFICER.

ACCORDING TO DEFENSE CONTRACT AUDIT AGENCY STATISTICS, PRICE ADJUSTMENTS MADE UNDER THIS ACT OVER THE PAST FIVE YEARS HAVE TOTALLED $300 MILLION.

PUBLIC LAW 91-279. "COST ACCOUNTING STANDARDS" (1970)

THIS ACT ESTABLISHED STANDARDS TO BE USED IN COSTING DEFENSE CONTRACTS. DURING ITS OPERATION, THE COST ACCOUNTING STANDARDS BOARD PROMULGATED 19 STANDARDS TO ASSURE ACCURATE, CONSISTENT, AND EQUITABLE CHARGING OF COSTS TO DEFENSE CONTRACTS. THESE STANDARDS ALSO REQUIRE CONTRACTORS TO USE ESTIMATING SYSTEMS THAT

WERE IDENTICAL TO THE ACCOUNTING SYSTEMS. IF THE CONTRACTOR IS FOUND TO BE IN NONCOMPLIANCE WITH THESE STANDARDS, THE CONTRACTING OFFICER HAS THE UNILATERAL RIGHT TO PRICE ADJUSTMENTS. ALTHOUGH THE BOARD DISCONTINUED OPERATIONS IN 1980, THE STANDARDS REMAIN APPLICABLE TO DEFENSE CONTRACTING.

PUBLIC LAW 95-142. "INSPECTOR GENERAL ACT" (1978)

THE OFFICE OF THE INSPECTOR GENERAL WAS ESTABLISHED FOR THE PURPOSE OF INCREASING ECONOMY AND EFFICIENCY. WITHIN THE DEPARTMENT OF DEFENSE, THE INSPECTOR GENERAL HAS A STAFF OF PROFESSIONALS WHO REGULARLY PERFORM AUDITS AND INSPECTIONS IN MANY AREAS, INCLUDING PROCUREMENT. EVEN THOUGH IT IS A RELATIVELY NEW FUNCTION, THE INSPECTOR GENERAL HAS ALREADY MADE SUBSTANTIAL CONTRIBUTIONS TO THE PROCUREMENT PROCESS.

REGULATORY ACTIONS

WEIGHTED GUIDELINES METHOD (1964)

THIS METHOD PROVIDES CONTRACTING OFFICERS WITH A UNIFORM APPROACH TO ESTABLISHING PRENEGOTIATION PROFIT OBJECTIVES. IT REQUIRES USE OF A STANDARDIZED FORM (DD FORM 1547) FOR ANALYZING PROFIT ON AN ELEMENT-BY-ELEMENT BASIS WHICH TAKES INTO ACCOUNT THE CONTRACTOR'S TECHNICAL RISK, COST RISK, AND AMOUNT OF FACILITIES CAPITAL EMPLOYED. THE WEIGHTED GUIDELINES METHOD PROVIDES FOR A GREATER DEGREE OF CONTROL OVER CONTRACT PROFIT.

IN ADDITION, FOR MOST NEGOTIATED CONTRACTS, CONTRACTING OFFICERS ARE REQUIRED TO SUBMIT A REPORT ON NEGOTIATED PROFIT (DD FORM 1499) TO A CENTRAL DATA BANK. THIS PROVIDES THE DEPARTMENT OF DEFENSE A STATISTICAL DATA BASE FOR REVIEWING TRENDS.

DEFENSE CONTRACT AUDIT AGENCY (1965)

A SEPARATE CONTRACT AUDIT AGENCY WAS ESTABLISHED in 1965. CONTRACT AUDITORS ARE HEAVILY INVOLVED IN ALL FACETS OF CONTRACT PRICING AS THEY ARE THE PRINCIPAL FINANCIAL ADVISORS TO THE CONTRACTING OFFICER. THE DEPARTMENT HAS INSTALLED SEVERAL REQUIREMENTS WHICH GIVE THE AUDITOR A LARGE ROLE IN ASSURING THAT CONTRACT PRICES ARE FAIR AND REASONABLE. IN ADDITION, THE PERSONNEL STRENGTH OF THE AGENCY HAS INCREASED BY 30% DURING THE PAST THREE YEARS, WITH ANOTHER 220 AUDITORS ESTIMATED FOR 1986.

COST MONITORING REVIEW PROGRAM (1978)

THIS PROGRAM CONSTITUTED A SIGNIFICANT ADVANCEMENT IN THE GOVERNMENT'S SURVEILLANCE OVER CONTRACTOR INDIRECT EXPENSES. A FORMAL GOVERNMENT PROGRAM IS REQUIRED AT CONTRACTOR LOCATIONS WHERE (1) SALES ON FLEXIBLY PRICED CONTRACTS SUCH AS FIXED PRICE INCENTIVE CONTRACTS, EXCEED $50 MILLION, (2) THE GOVERNMENT'S SHARE OF THE CONTRACTOR'S BUSINESS IS AT LEAST 50%, AND (3) THERE IS A LOCAL CONTRACT ADMINISTRATION OFFICE. COST MONITORING REVIEWS ARE PERFORMED TO IDENTIFY CONTRACTOR INEFFICIENCIES, AND IF WARRANTED, A NOTICE OF INTENT TO DISALLOW COSTS MAY BE ISSUED BY THE CONTRACTING OFFICER.

OVERALL ASSESSMENT

IN 1976 CONGRESS DECIDED THAT STATUTORY RENEGOTIATION WAS NO LONGER NECESSARY. THE MARGINAL BENEFITS OVER EXISTING CONTROLS WERE NOT WORTH THE ASSOCIATED COSTS.

STATUTORY RENEGOTIATION APPEALS TO SOME BECAUSE IT IS SUPPOSED TO CREATE A STRUCTURE WHICH GIVES THE PUBLIC CONFIDENCE THAT EXCESSIVE PROFITS WILL NOT BE PAID TO DEFENSE CONTRACTORS. THE GOVERNMENT WOULD BE ABLE TO TAKE BACK WHATEVER PROFITS WERE DEEMED EXCESSIVE AND NOT JUST ON AN AGGREGATE FISCAL YEAR BASIS AS UNDER THE RENEGOTIATION ACT OF 1951. CURRENT PROPOSALS WOULD ALLOW DETERMINATIONS TO BE MADE ON A DIVISION-BY-DIVISION, PRODUCT-BY-PRODUCT BASIS. LOW PROFITS OR LOSSES ON ONE PRODUCT COULD NOT BE NETTED AGAINST GAINS ON ANOTHER PRODUCT WHICH YIELDED HIGHER PROFITS. ALTHOUGH THERE MAY BE LIMITED APPEAL FROM AN APPEARANCE STANDPOINT, THERE ARE OTHER CONSIDERATIONS THAT ARGUE AGAINST REESTABLISHING THE RENEGOTIATION BOARD.

FIRST, ARE THERE EXCESSIVE PROFITS? A RECENT 18-MONTH STUDY PERFORMED UNDER THE DIRECTION OF THE DEPUTY SECRETARY, CALLED "THE DEFENSE FINANCIAL AND INVESTMENT REVIEW (DFAIR)" CONCLUDED:

"IN GENERAL, THE DFAIR ANALYSIS ... ARRIVED AT THE CONCLUSION THAT OUR CURRENT CONTRACT PRICING, FINANCING AND MARKUP POLICIES ARE BALANCED, ARE PROTECTING THE INTERESTS OF THE TAXPAYER, AND ARE ENABLING U. S. INDUSTRY TO ACHIEVE AN EQUITABLE RETURN FOR THEIR INVOLVEMENT IN DEFENSE BUSINESS." A COPY OF THE COMPLETE DFAIR STUDY HAS BEEN SUBMITTED TO THE SUBCOMMITTEE STAFF.

SECOND, THERE IS A MAJOR QUESTION ON THE FAIRNESS OF A DIVISION-BY-DIVISION, PRODUCT-BY-PRODUCT APPLICATION OF EXCESSIVE PROFIT DETERMINATIONS. IT IS A FUNDAMENTAL BUSINESS CONCEPT TO DIVERSIFY PRODUCT LINES IN ORDER TO SPREAD RISK. A NATIONAL POLICY FOR NOT ALLOWING LOSSES OR LOW PROFITS INCURRED ON ONE DEFENSE CONTRACT TO BE NETTED AGAINST PROFITS OF ANOTHER MAY WORK AGAINST THE PUBLIC INTEREST. IT WOULD CERTAINLY HAVE THE POTENTIAL FOR AFFECTING A CONTRACTOR'S MOTIVATION TO CONTROL COSTS, AND IT MAY AFFECT OTHER CONTRACT PERFORMANCE ELEMENTS LIKE DELIVERY SCHEDULES, QUALITY, CAPITAL INVESTMENT, ETC. THIS ASPECT OF STATUTORY RENEGOTIATION DESERVES SERIOUS ANALYSIS.

FINALLY, THERE IS THE QUESTION OF MARGINAL BENEFIT OF STATUTORY RENEGOTIATION OVER ITS MARGINAL COST. CURRENT CONTROLS ENACTED BY CONGRESS, ADOPTED BY THE EXECUTIVE BRANCH, OR IMPLEMENTED AS DEPARTMENTAL POLICY PROVIDE ADEQUATE CONTROL OVER EXCESSIVE PROFIT.

IN SUMMARY, I THANK THE SUBCOMMITTEE FOR ALLOWING THE DEPARTMENT TO PRESENT THOUGHTS ON STATUTORY RENEGOTIATION. ALTHOUGH WE OPPOSE THE PRESENT LEGISLATIVE PROPOSALS, WE DO NOT WANT CONTRACTORS TO RECEIVE EXCESSIVE PROFITS AND WILL DO WHATEVER IS NECESSARY TO SEE THAT IT DOES NOT HAPPEN.

MR. CHAIRMAN, THIS CONCLUDES MY STATEMENT.

Chairman HUBBARD. Thank you very much, Eleanor Spector.

Accompanying you from the Defense Department are representatives from the Army, Air Force, Navy, and Defense Contract Audit Agency, who will be available to answer any questions?

Ms. SPECTOR. Yes, sir.

Chairman HUBBARD. About specific projects in which the Members are interested?

Ms. SPECTOR. Yes.

Chairman HUBBARD. Now we will call on Paul Math to be our next witness.

STATEMENT OF PAUL F. MATH, ASSOCIATE DIRECTOR, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. MATH. Thank you, Mr. Chairman.

First of all, Clark Adams, a group director in our organization, is also with me and will be available during the question and answer period to answer any of your questions.

First of all, I am pleased to appear before the subcommittee to discuss H.R. 3020, the War Profiteering Prohibition Act of 1985, a bill to revise and reinstate the Renegotiation Act of 1951.

As Mr. Bowsher indicated in his testimony before this subcommittee on March 21, 1984, we are concerned about the increase in defense spending and the ability of the Department of Defense to ensure that contractor profit levels are fair and equitable. At that time, we reported that the net value of DOD prime contracts had risen from $32.5 billion in 1974 to $120 billion in 1983. In 1984, the figure had risen to $125 billion. This procurement figure has continued to rise. DOD's authorization for procurement in 1985 was $131 billion and the proposed procurement authorization for 1986 is $132 billion.

I am sure we all agree that defense contractors should be allowed to make an appropriate level of profit on these procurements. However, the appropriate level of profits on Government contracts has long been a subject of debate. In these debates, there is a clear understanding that contractors must anticipate earning an adequate profit before they will invest shareholder resources to perform Government contracts. It is generally agreed that profits earned by contractors under defense contracts have a significant effect on our defense industrial base.

In the mid-1970's, DOD was concerned with what was believed to be unacceptably low levels of investment by defense contractors. Some believed that the low profits awarded on Government contracts caused this lack of investment. In May 1975, the Deputy Secretary of Defense directed a major study of capital investment, profit and productivity. This study, known as Profit '76, set out to develop policy revisions that would encourage contractors to invest in capital assets which would reduce production costs.

The study resulted in adjustments to the weighted guidelines used by contracting officers to establish Government negotiating positions. These adjustments reduced the percent of profit based on cost and created a profit factor on the capital facilities devoted to the contract. By making these changes, DOD believed it was creating appropriate incentives for contractors to invest in productivity enhancing capital facilities.

Because of the significant increase in defense spending and our concern that this buildup not result in excessive profits, we, along with others, recommended that DOD conduct another comprehensive review of its profit policy. This study, as Eleanor mentioned, entitled "Defense Financial And Investment Review," DFAIR, was announced by the Deputy Secretary of Defense in December 1983. While DOD's intent was to conduct a study along the lines of Profit '76, the effort was somewhat broader in scope in that it examined DOD financing and pricing policies as well as their appropriate integration with profit policy.

That study has now been completed, and we, at the request of several congressional committees, recently initiated our review of the adequacy of the study, the validity of its findings, and the appropriateness of its recommendations. We expect to issue our report next year.

The legislation we are addressing today would reauthorize the Renegotiation Act of 1951 with a termination date of September 30, 1988. It would also amend the act to require the Contract Renegotiation Board to renegotiate all contracts and subcontracts by division, and by major product line within a division, of the contractor or subcontractor.

We share the concern implicit in this bill regarding the level of contractor profits. However, we believe that rather than reinstating the Renegotiation Act of 1951, legislation requiring periodic studies of contractor profit should be enacted. The legislation should provide that the studies be based on data provided through a mandatory defense contractor profitability reporting system.

The periodic studies should be designed to provide the information necessary to guide overall DOD profit policy. We believe this is preferable to reestablishing a renegotiation board, even one designed to renegotiate by contractor division and product line, because:

First. A renegotiation board takes back profits already negotiated and earned by contractors, and our recommended profit policy based on regular and mandatory reporting should be designed to provide contractors with an appropriate level of profits in the first place.

Second. A renegotiation board would require contractors to file financial data which may be very similar to the data provisions we envision under a periodic profit reporting system. However, our suggested solution would use this data for a prospective, forward-looking approach to adjusting contractor profit.

As mentioned earlier, DOD's comprehensive review of its pricing, financing and profit policy, DFAIR, is now complete. One of our concerns about the validity of this study is that it is based on unaudited data voluntarily submitted by defense contractors. We cautioned that such unaudited data may not be a satisfactory basis for a reliable profitability analysis. Decisions regarding long-term DOD profit policy which are based on voluntary, and possibly incomplete data, will suffer from inherent weaknesses.

In our November 9, 1984, letter we recommended that a requirement for periodic profit studies, based on regularly reported data on defense contract profitability, be established. The fundamental areas to be addressed in these periodic studies would include: First, the actual profits earned and level of investment under defense contracts: second, how the profitability and investment behavior of defense contractors compares with firms in other industries and with the private sector as a whole; and third, whether variations between the profitability of defense contracts and other industries are justified given the circumstances.

The periodic studies would allow DOD to make continuing adjustments in its profit policy on a regular basis rather than make major changes every 10 years.

The studies would be based on data developed from a mandatory profitability reporting system. This would require annual reporting of profitability by contractor segments engaged in defense work. The reports would be reconcilable to the corporate financial statements and would be reviewed by the company's certified public accounting firm. Once operational, this reporting system would yield reliable information on the profitability of defense work which would make meaningful periodic studies possible.

If the overall profit policy that develops out of the DFAIR profit study is structured correctly, if a requirement for mandatory annual reporting is established, and if periodic reviews are made to validate the results being obtained by the policy, DOD will be able to monitor profits on a continuing and timely basis, and make the policy adjustments that are necessary to ensure that profits remain at reasonable levels.

In conclusion, let me say again that we share your concerns that defense contractor profits should be at an appropriate level. However, we believe the way to address this issue is to establish a systematic procedure to periodically review and, if necessary, alter DOD's overall profit policy, rather than reestablishing the Contract Renegotiation Board.

Mr. Chairman and members, this concludes my statement.

[The prepared statement of Mr. Math follows:]

STATEMENT OF PAUL F. MATH, ASSOCIATE DIRECTOR, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before the Subcommittee to discuss H.R. 3020, the "War Profiteering Prohibition Act of 1985", a bill to revise and reinstate the Renegotiation Act of 1951.

As Mr. Bowsher indicated in his testimony before this Subcommittee on March 21, 1984, we are concerned about the increase in defense spending and the ability of the Department of Defense (DOD) to ensure that contractor profit levels are fair and equitable. At that time, we reported that the net value of DOD prime contracts had risen from $32.5 billion in 1974 to $120 billion in 1983. In 1984 the figure had risen to $125 billion. This procurement figure has continued to rise. DOD's authorization for procurement in 1985 was $131 billion and the proposed procurement authorization for 1986 is $132.7 billion

I am sure we would all agree that defense contractors should be allowed to make an appropriate level of profit on these procurements. However, the appropriate level of profits on government contracts has long been a subject of debate. In these debates, there is a clear understanding that contractors must anticipate earning an adequate profit before they will invest shareholder resources to perform government contracts. It is generally agreed that profits earned by contractors under defense contracts have a significant effect on our defense industrial base.

In the mid-1970s, DOD was concerned with what was believed to be unacceptably low levels of investment by defense contractors. Some believed that the low profits awarded on government contracts caused this lack of investment. In May 1975, the Deputy Secretary of Defense directed a major study of capital investment, profit, and productivity. This study, known as Profit '76, set out to develop policy revisions that would encourage contractors to invest in capital assets which would reduce production costs. The study resulted in adjustments to the weighted guidelines used by contracting officers to establish government negotiating positions. These adjustments reduced the percent of profit based on cost and created a profit factor on the capital facilities devoted to the contract. By making these changes, DOD believed it was creating appropriate incentives for contractors to invest in productivity enhancing capital facilities.

Because of the significant increase in defense spending and our concern that this buildup not result in excessive profits, we, along with others, recommended that DOD conduct another comprehensive review of its profit policy. This study, entitled Defense Financial and Investment Review (DFAIR), was announced by the Deputy Secretary of Defense in December 1983. While DOD's intent was to conduct a study along the lines of

Profit '76, the effort was somewhat broader in scope in that it examined DOD financing and pricing policies as well as their appropriate integration with the profit policy.

That study has now been completed, and we, at the request of several congressional committees, recently initiated our review of the adequacy of the study, the validity of its findings, and the appropriateness of its recommendations. We expect to issue our report next year.

The legislation we are addressing today would reauthorize the Renegotiation Act of 1951 with a termination date of September 30, 1988. It would also amend the act to require the Contract Renegotiation Board to renegotiate all contracts and subcontracts by division, and by major product line within a division, of the contractor or subcontractor.

We share the concern implicit in this bill regarding the level of contractor profits. However, we believe that rather than reinstating the Renegotiation Act of 1951, legislation requiring periodic studies of contractor profit should be enacted. The legislation should provide that the studies be based on data provided through a mandatory defense contractor profitability reporting system. The periodic studies should be designed to provide the information necessary to guide overall

DOD profit policy. We believe this is preferable to reestablishing a renegotiation board, even one designed to renegotiate by contractor division and product line, because:

(1) A renegotiation board takes back profits already negotiated and earned by contractors--changes to profit policy based on regular and mandatory reporting should be designed to provide contractors with an appropriate level of profits in the first place.

(2) A renegotiation board would require contractors to file financial data which may be very similar to the data provisions we envision under a periodic profit reporting system. However, our suggested solution would use this data for a prospective, forward-looking approach to adjusting contractor profit.

As I mentioned earlier, DOD's comprehensive review of its pricing, financing, and profit policy (DFAIR) is now complete. One of our concerns about the validity of this study is that it is based on unaudited data voluntarily submitted by defense contractors. On November 9, 1984, we sent a letter to the Secretary of Defense expressing our concerns regarding the accuracy and reliability of data voluntarily provided by contractors. We cautioned that such unaudited data may not be a satisfactory basis for a reliable profitability analysis. Decisions regarding long-term DOD profit policy which are based on voluntary, and possibly incomplete, data, will suffer from inherent weaknesses.

In our November 9, 1984, letter we recommended that a requirement for periodic profit studies, based on regularly reported data on defense contract profitability, be established. The fundamental areas to be addressed in these periodic studies would include (1) the actual profits earned and level of investment under defense contracts, (2) how the profitability and investment behavior of defense contractors compares with firms in other industries and with the private sector as a whole, and (3) whether variations between the profitability of defense contracts and other industries are justified given the circumstances. The periodic studies would allow DOD to make continuing adjustments to its profit policy on a regular basis rather than make major changes every 10 years.

The studies would be based on data developed from a mandatory profitability reporting program. This would require annual reporting of profitability by contractor segments engaged in defense work. The reports would be reconcilable to the corporate financial statements and would be reviewed by the company's certified public accounting firm. Once operational, this reporting system would yield reliable information on the profitability of defense work which would make meaningful periodic studies possible.

If the overall profit policy that develops out of the DFAIR profit study is structured correctly, if a requirement for mandatory annual reporting is established, and if periodic reviews are made to validate the results being obtained by the policy, DOD will be able to monitor profits on a continuing and timely basis, and make the policy adjustments that are necessary to ensure that profits remain at reasonable levels.

In conclusion let me say again that we share your concerns that defense contractor profits should be at an appropriate level. However, we believe the way to address this issue is to establish a systematic procedure to periodically review and, if necessary, alter DOD's overall profit policy, rather than reestablishing the Contract Renegotiation Board.

This concludes my prepared statement. I will be pleased to answer any questions the Subcommittee may have.

Chairman HUBBARD. Thank you very much, Mr. Paul Math of GAO.

The first question is to Miss Spector of DOD. What impact would H.R. 3020, with after-the-fact profit review, have on incentive contracts? Would it not reduce the motivation to accept incentive contracts?

Ms. SPECTOR. No; I don't think it would reduce the motivation to accept incentive contracts. It would reduce the motivation to reduce costs is the problem because the more you reduce costs on fixed price contracts, including incentive contracts, the more profit you get.

If contractors are concerned about that, there could be an attempt not to do things that will reduce costs overall. I perceive that could occur on any fixed price type contract. I am not sure the specific implication you are looking for. We could disincentivize cost cutting in general.

Chairman HUBBARD. On page 13 of your testimony, you state that "Current controls enacted by Congress or implemented as Department policy provide adequate control over excessive profit."

Are you stating there that the Department of Defense does not believe there are problems with excessive profits?

Ms. SPECTOR. I don't think we could say that. It is difficult to define what is excess. I don't think it is a widespread pervasive problem. The Renegotiation Board in their last year of existence recovered about $30 million which, given the magnitude of what we were doing even then, is not a lot of excess profit.

In the areas of competition, I would say we probably have no business looking at their profits where we are getting adequate competition.

In the remaining 50 percent or so where we are not getting competition, we do perform thorough cost analyses, we don't just accept prices that are quoted. We do detailed cost analyses and I think the provisions that are in place do protect us going in from paying extremely high costs.

If a person has productivity improvements or underruns, he might make more than we thought he was going to make when we went in. On the other hand, he shares the same risk on the other side that he could make considerably less. By and large, our experience is that he is making less than what we negotiated with him going in.

Chairman HUBBARD. What is a "defective price" in terms of the Truth in Negotiations Act? Can you give us an example of a defective price situation?

Ms. SPECTOR. The bulk of them occur actually in the subcontract area. It is where they don't give us accurate, current, and complete costing data when we negotiate with them. The area that we see it most often is they will have a list of hundreds of subcontractors on a major weapons system, for instance. When we conclude that negotiation, we expect all of those prices to be what they have actually negotiated or their latest quote.

In some cases because of lateness, whatever, we don't get the latest quote or the latest price and can wind up paying a price that is higher than what they have just concluded negotiation on. In that case, we go back and collect the difference from them. That is the biggest area of defective pricing we see and some of it, I think, is accidental. They don't update the records in time to give us their latest negotiated quotes. We go after it nevertheless. That is the biggest area of defective pricing we have observed.

Chairman HUBBARD. Congress through the years has enacted more laws to control defense procurement. Would you agree that enough laws have been enacted to give the DOD the ability to negotiate good prices, including profits for the products you buy?

Ms. SPECTOR. Yes; we have more than enough legislation. It is slowing us down quite a bit, affecting our efficiency, coping with all the new legislation that we have received.

Chairman HUBBARD. On page 9 of your prepared statement, you state that DCAA statistics indicate that price adjustments made under the Truth in Negotiations Act over the past 5 years have totaled $300 million. Of course, that is a lot of money, but compared to total defense procurement expenditures over the past 5 years, it seems to be a tiny fraction.

Do you think that this tiny fraction is at all commensurate with the amount of excessive profits we have paid in the past 5 years?

Ms. SPECTOR. I am not sure I can comment on that. I have trouble with the definition of excessive profits, particularly when you apply it to a corporation. As far as defective pricing, I heard a recent presentation by the inspector general who said it is a small percent of contractors that are involved in defective pricing. In the sample the inspector general looked at, which was picked because of its expected vulnerability to defective pricing—it is contractors we caught at defective pricing before—the inspector general only came up with about 4 percent of defective pricing and they admit it was not a random sample, so I don't think defective pricing is a tremendous problem. Are we getting all the excess profits, I have a hard time answering that.

Chairman HUBBARD. How effective do you believe the Truth in Negotiations Act is?

Ms. SPECTOR. I believe it is quite effective. Having been a contract negotiator, we get virtually all the data we ask for. The data we weren't getting here was data that involved internal audits of a company. It wasn't specifically cost or pricing data on contracts. I have never been denied any data that I have asked for involving cost or pricing data on a contract that I was pricing, so I believe we are getting what we need to do our job properly.

Chairman HUBBARD. One last question would be a question regarding the media's emphasis upon excessive profits for spare parts. Some of the liberals in Congress like to dwell on that as we debate defense authorizations and appropriations. Recently, DOD requested comments from 30 major contractors on a proposed policy that would require refunds on spare parts fraud to be overpriced.

Would you elaborate on the background and reasoning behind this request?

Ms. SPECTOR. I think you meant to say "found to be overpriced."

Chairman HUBBARD. Found to be overpriced, excuse me.

Ms. SPECTOR. One of Secretary Weinberger's original spare parts initiatives was to seek refunds any time we believed we had been overcharged. In response to that initiative, several major defense contractors established voluntary refund policies. While the response from those contractors was very positive, each of their proposals represented a slightly different approach to handling refunds. To prevent proliferation of multiple refund policies, DOD developed a single refund policy, which was coordinated with industry and the Military Services. The standard DOD policy clearly shows our intent to seek a refund or a negotiated price adjustment whenever and wherever we believe the price paid for spare parts or support equipment is unreasonable.

Chairman HUBBARD. Based on your comments on that, would you tell us if the Pentagon has received any refunds to date through utilization of this policy?

Ms. SPECTOR. Yes, sir, we have. I will have to provide that for the record, but, yes, we have received voluntary refunds and I don't have the amount with me here.

[The response to the request of Chairman Hubbard, the following information was submitted for the record by Ms. Spector:]

VOLUNTARY REFUNDS

Since the beginning of fiscal year 1985, we have received approximately $19 million in voluntary refunds. These refunds were not in response to the standard DOD refund policy, which we just issued on November 1, 1985. But they were in direct response to the original Secretary Weinberger initiatives to pursue refunds agressively anytime we believe we have been overcharged.

Chairman HUBBARD. Mr. Math, I will be brief knowing there are other members who have questions for both of you. Our subcommittee has conducted hearings on this issue of defense contract profits for several years. It seems that the General Accounting Office is constantly pointing to studies, reports, regulations, and standards.

The question to you is, How much success are we having in preventing excessive profits?

Mr. MATH. The problem we have found with regard to the studies is that we have not, nor has DOD, had access to the data that is the basis of those studies. Contractor data was provided on a voluntary basis, both for the 1976 study and the current DFAIR study. DOD went out and requested data on a voluntary basis. They did not have access to the raw data. The contractors provided that data to a CPA firm, which then consolidated the data and put it together in a package provided to DOD.

No one in the Government was able to audit the data, so the problem that we see is that there should be a mandatory reporting system available to DOD, available to some agency of the Government so that it can be audited to determine whether there are excessive profits or not. I think that mandatory reporting and verifiable data are keys in determining whether there are or are not excess profits.

Chairman HUBBARD. On page 2 of your testimony, you refer to the Profit '76 study, and you have just mentioned that study, which you say resulted in adjustments to the weighted guidelines used by contracting officers to establish Government negotiating positions. How effective have these adjustments been in encouraging contractors to invest in capital assets?

Mr. MATH. According to the DFAIR study, and we have not recently looked at the effects of the current weighted guidelines and the profits on investment, but according to that study, the investments have increased but DOD could not directly correlate those investments to the profit policy. In fact, there was some indication, and we haven't taken a good look at that yet, but there were some indications that there may not be a direct correlation between the profit policy and investment in productivity enhancing equipment.

I think DOD's position was that we ought to incentivize investment differently and change the factors. They currently have facilities capital employed factors which are applied to land, buildings, equipment, et cetera, and the recommendation of the DFAIR study is to adjust those profit factors to emphasize productivity enhancing equipment rather than things like land and buildings that don't increase productivity as much.

Chairman HUBBARD. You suggest passage of legislation by Congress requiring periodic studies of contractor profit in your testimony. What type legislation and what kind of timeframe are you suggesting for these studies? Who would do the studies?

Mr. MATH. The studies would be done presumably by DOD, and they could be done at least every 2 to 3 years. You would have the data available through the mandatory reporting system to do them as frequently as you wanted. You could have a continuous evaluation of the date on a yearly basis to determine whether the profits are in fact fair and reasonable.

DOD could perform profit studies on an annual basis or a 2- to 3-year basis, and then organizations such as GAO could take a look at the studies, and take a look at the data to see if we are in fact paying appropriate profits.

Chairman HUBBARD. Lastly, giving other Members a chance here, what about the GAO doing audits? Haven't you recently sent auditors into 10 of our 50 largest defense contractors to focus on subcontract pricing and cost estimating? Do you have any comments on the reasoning for these audits or on the progress of these audits?

Mr. MATH. The audits were initiated because as with profits, and the concern about excessive contractor profits when the defense dollars are increasing at the rate they have been increasing, we were also concerned with the pricing actions and how effective DOD is in determining whether we are achieving fair and reasonable prices. We initiated an overview effort, and went out to 10 contractors, talked to DCAA, talked to DOD, talked to the contractors to determine what areas we thought GAO should emphasize.

We picked five areas initially and you mentioned a few of them. Cost estimating systems, subcontractor pricing, forward pricing rate agreements, technical evaluations, and unpriced orders. We have completed what we call the first phase of that effort and we testified on October 3 on three of the issues. One of them was our cost estimating—DOD surveillance and cost estimating—another was subcontractor pricing and the third was on overhead, looking especially at allowable overhead costs.

Eleanor mentioned DOD's concern about subcontracting pricing. Our effort basically showed that there are considerable problems with prospectively priced subcontracts. By that we mean that the prime contractor has obtained information from the subcontractor on the costs so that he can prepare to negotiate with the Government. The prime contractors' evaluations of that data was minimal before the prime contract was negotiated with the Government.

Prime contractors negotiated with the Government, established the contract price, and then went to the subcontractors after conducting more indepth reviews of the data, and knocked down subcontractors' prices significantly. For the contracts we looked at there was about a $42 million reduction between the prices negotiated between the prime contractors and the Government and the prices the prime contractors negotiated with their subcontractors.

So we are in the contractor plants.

In our next effort we will look at contractor cost estimating methods and practices. We will also look at defective pricing at 10 contractor plants in our second phase.

We are going to do some work for Senator Proxmire in looking at markup costs in major weapon system contracts, the costs that are associated and added to labor and material as you price a contract.

We have several initiatives underway in the pricing area and we will continue to perform audits in this area for some time.

Chairman **Hubbard**. Forgive me, fellow colleagues, for taking one more moment before I call on Congressman Parris.

You were not a part of the GAO audit, but Big Rivers Electric Corp. in my district, Henderson, KY. owes the Rural Electrification Administration $1.2 billion. That is more money than Congress is allocating to REA to operate in 50 States during fiscal year 1986; $1.2 billion is what Big Rivers Electric Corp. owes the Federal Government. They haven't made a payment since September of last year. They do not give out bids for their insurance business. They give it to one firm outside my congressional district, a firm which has made multimillions of dollars off this agency. One partner is a Member of Congress who reported last year that from the insurance company, he received unearned income of $263,000.

I asked GAO to do an audit. This electric corporation also has one law firm outside my district in Kentucky to whom they pay millions of dollars, and they paid a New York City law firm last year over $1 million in legal fees.

GAO found absolutely nothing wrong, nothing irregular at all, and didn't even suggest that Big Rivers Electric Corp. give bids for their insurance business with one company handling it all, property damage, employee benefits, et cetera.

I guess that sort of tarnished my image of the GAO, but we are glad to have you with us.

Now we will call on Congressman Stan Parris.

Mr. **Parris**. That was the bad news. The good news is that GAO did a study on a savings and loan institute that I introduced into the record yesterday and I thought it was outstanding.

Several quick questions. The bottom line of both of your testimony, as I read it, is you do not see any justification for need during peacetime to reinstate the Board; is that correct? Yes or no?

Ms. **Spector**. That is correct.

Mr. **Math**. I wouldn't say there is no justification or need for the Board. The alternative we are proposing, we think, is a better alternative. Once you have this regularly reported data and you find that the process and the system is not working, you may need to, whether you call it renegotiation board or whatever, you may need to take action down the road.

We don't think that action is necessary now, but with the data reporting requirement we are proposing, you can determine what the most appropriate action is.

Mr. **Parris**. Ms. Spector says that current controls enacted by Congress adopted by the executive branch or implemented as departmental policy provide adequate control over excessive profit. Do you agree with that?

Ms. **Spector**. I do.

Mr. **Math**. Do I——

Mr. **Parris**. Yes.

Mr. **Math**. I think the controls are there. I cannot say they always work, but I would say that the controls are there.

Mr. **Parris**. You would agree with the statement that they do provide adequate control? It is not a perfect world, Mr. Math, OK?

Mr. **Math**. I agree.

Mr. **Parris**. If I understood your comments, Ms. Spector, you said that the congressional controls, legislative or otherwise, are reducing the efficiency of your office to monitor these contract proceedings, not in fact improving it; is that correct?

Ms. **Spector**. Specifically it is not the efficiency of my office. We do policy. In the field, we are hearing of greatly lengthening procurement leadtimes as a result of a lot of the legislation. One individual piece of legislation can't be attacked. Each of it in and of itself is not bad. It is good. It is when you pile on a lot of new legislation that you wind up——

Mr. **Parris**. One piece of—what you are really saying is you are strangling on the paperwork; isn't that correct?

Ms. **Spector**. To a large extent, yes, we are.

Mr. **Parris**. One last question, Ms. Spector.

If there is adequate controls in the existing legislation or departmental policy or whatever to police excess profit, how do you explain the toilet seats and the $600 hammers and so forth? Are we totally ignoring the millions of items that are competitively bid and in which there is some adequate but reasonable profit and these are the ones that we always point at like the person who hatchets his wife to death when he goes home instead of the millions who go home and have dinner with their children.

Is that what we are doing?

Ms. **Spector**. To a certain extent, yes. We do 15 million procurement actions a year. If 1 percent of them were bad, we would have 150,000 bad ones and I don't think we have that many.

Yes, we are harping on ones where we have either made errors, done things foolishly, had things overdesigned, and we have set about correcting those so that each of the services has an extensive program underway to eliminate all of these.

We have it underway. That is not to say that we are not going to find any more, not to say that stuff designed 20 years ago that we have to spare is not going to be overspecified, and we have to keep buying the spares. We have many internal reforms, many imposed by Congress, give us a chance to do them is what I am really saying.

Mr. Parris. Thank you.

Chairman Hubbard. Thank you, Congressman Parris.

Now Congressman Gonzalez.

Mr. Gonzalez. Thank you, Mr. Chairman, and thank the two witnesses for being here this morning and sharing this time with us.

As I said earlier, the consensus is we are all against sin, we are all against excess profit. The difficulty is that nobody can define profit.

Ms. Spector, you just said, well, you didn't know anything about what would be excess profit because you can't define it.

Mr. Math, you said, well, what we ought to do is study this, follow through and try to determine and have studies on profitability, but then what do you do? You have no mechanism to recover.

You, Ms. Spector, have a definition, and you negotiate at a given moment at a certain level, but then you don't follow through.

The Defense Department has been unwilling to follow through and study profitability and follow through on a definite basis. But since you dwell quite a bit on defective pricing—I still didn't get a clear idea of what and how you define defective pricing.

Let's take specific items: A $200 stool cap, was this defective pricing, or fraud, or shear human folly? The case of the $400 hammer and the high-priced toolkit, would this represent defective pricing, fraud, or an overhead accounting system that has run amok?

When there is an excessive price charge because of defective pricing, the DOD can reduce the price by its own unilateral action. How many cases are there so far this year?

Ms. Spector. Sir, let me say I really can't define profit. When we get into what is excessive and we set a mark, is it 30 percent, 20 percent, that is where I have difficulty. There is no clear definition.

If a contractor becomes extremely efficient, for instance——

Mr. Gonzalez. At the negotiating level, of course, but what do you do to follow through after that?

Ms. Spector. We do look at actuals when we have follow-on contracts, and we have a general idea of what actual costs were on contracts. We have a very good idea of what actual costs were on contracts.

We also have done two major studies where we have looked at profits, coming out profits, and I think we have generally satisfied ourselves that we are not thoroughly out of line.

I will answer a couple of questions on the spares that you asked.

Mr. Gonzalez. Also, that last one about how many cases this year, for instance and you have unilateral recovery.

Ms. Spector. When talking about the spares, a lot of the time problem cases with spares are low-dollar value items bought in very small quantities from prime contractors. By and large, those spares would not show up were a renegotiation board to go in and look at some of these very large contractors.

Now, we won't give them a stool cap to look at. You would look at as a minimum, the whole product line, which would be the airplane itself, or all the airplanes they build. I doubt those spares would even really show up as being excess profits, and on most of them, excess profits were not made.

In the case of the stool cap, it was overdesigned. There were 20 separate tooling steps, it was an overdesigned part. When it was caught, we are no longer buying it.

In the case of a lot of these things, there were reasons beyond excess profits. We were putting prime contractor overheads on spares, and perhaps we should have broken them out and gone directly to the manufacturer; perhaps they were overdesigned, but in most cases, contractors were not making exorbitant profits on them.

The toilet seat is an example of a specially designed part for a special area. Whether that is necessary, one can question, but were they making a lot of profit on it? They were not.

How many cases, I don't know. Of course, there are more than we would like. Percentagewise, they are not large.

Mr. GONZALEZ. You talk say about a special part for a special place.

Let me be a little more specific in an area that is away from these horror stories. The F-100 jet engine was originally contracted with Pratt & Whitney. After competition, the follow-on contract went to GE at substantially reduced prices.

Was Pratt & Whitney making an excessive profit? What was the Pratt & Whitney profit? Did the Government error determine the real profit? Could it do so today?

Ms. SPECTOR. I will have the Air Force answer that, but can I address another point you made?

Most of the spares horror stories that you have heard have been aircraft spare parts. Things like clothing are usually bought competitively, and I don't think we have pricing horror stories on those. These are aircraft spare parts, by and large, bought from prime contractors in very low quantities.

Mr. GONZALEZ. That is true. That is the reason I picked on that, because we are getting sidetracked.

When you did have the Renegotiation Board and perhaps even in its heyday, you did have some horror stories. I remember one 20-some years ago where a—some kind of a nut and bolt that you could go to Kresge's and get a whole flock at that time for 20 cents was costing the Government $30. But that is a very different area of procurement, and we are kind of straining away.

I think this question that I am asking with the specific instance of the F-100—another one, Vaught Aerospace did it, earn a profit or incur a loss on the DIVAD gun system that was recently scrapped or canceled. Precisely how much profit or loss? What is the profit level on the M-1 program's tank? When the Navy buys the P-2, what is the profit level?

Defense procedures require a negotiated profit. This is what the Department refers to as apparent proof.

Can it determine with any precision what the real profit is on any given contract? Was the Renegotiation Board able to determine real profit levels?

I think the history there speaks for itself and the record of litigation that resulted from the Board's determinations but I don't see that and I don't see that in your silent opposition to any type of effort to reinstate or reimpose a congressional policy.

What has happened since 1979 is very significant because the Congress turned over to the Defense Department to do something that by its very nature and its procedural methods and powers and ability to is not in a position to do. If we do another study and follow through studies, which the Defense Department is not doing now, on profitability, there then is nothing, nothing GAO can do to retrieve that excess profit.

This is the reason that the recorded experience of such a device as the Renegotiation Board is what we constantly must go back to, and in these specific areas that I am asking, I know that it will take time, and if the answer can be forthcoming for the record, I will be satisfied with that. I don't expect you to answer this at this point.

I think the significant thing is that unless and until we not only have a congressional policy defining excess profit, and then the mechanism and the policies to proceed forward to retrieve those excess profits to the taxpayer of this country, we are not getting any place and we will continue to have horror stories.

The real horror stories are not being reported because nobody really knows. There is no standard by which we can gauge the extent.

But just on the basis of the procurement level in the noncompetitive and in the negotiated procurements, at the levels we have now, compared to the high points in past eras, the Korean high point, the Vietnam high point, and the track record with a toothless agency—for about a year and a half, some on the staff and off the staff, we have extrapolated that there would be a minimum, a minimum of $10 billion in excessive profits right now as of last year, and I just think that we have got to see that the basic issue is not whether we agree or disagree at the dastardliness of excessive profits, but the need to impose a congressional policy.

Since 1979, it has been literally turned over to the Defense Department and you yourself admit here this morning that you have no way really of determining what is excess profit, though you are against it.

Mr. Chairman, I know I have used up more than my allotted time.

Chairman **Hubbard**. Thank you.

Mr. **Gonzalez**. Excuse me. I ask unanimous consent that I may submit for the record some additional questions in writing in time for the witnesses to receive their transcript of the proceedings and address the questions.

Chairman **Hubbard**. Without objection, so ordered, and certainly as a sponsor of the legislation about which this hearing is being held, we weren't going to limit you on time.

Questions Submitted by Congressman Gonzalez to Ms. Spector With Attached Responses

APPARENT PROFIT VERSUS REAL PROFIT

Question 1A. The F-100 jet engine was originally contracted with Pratt and Whitney. After competition, the follow-on contract went to GE, at substantially reduced prices. Was Pratt & Whitney making an excessive profit?

Ms. **Spector**. The reduced price was a reflection of the benefits that can be gained from competition. However, the reduced price, by itself, should not serve as an indication of excessive profit that may have been earned by the previous contractor. Two contractors can have substantially different prices but have the same profit rate. This could be caused by differences in manufacturing costs, difference bases for spreading fixed costs, etc.

Question 1B. What was the Pratt & Whitney profit? Did the government ever determine the real profit? Could it do so today?

Ms. Spector. The F-100 jet engine contracts that has been awarded to Pratt and Whitney prior to the competition with General Electric had negotiated profit rates of roughly 13.5%. These are pre-performance rates and would ultimately be reduced by expenses incurred by the contractor but not allowed under our regulations as contract cost (e.g., interest expense, charitable contributions). These engine contracts were fixed price; therefore, real profits do not have to be reported to the Air Force by the contractor.

Question 1C. Did Ford Aerospace earn a profit or incur a loss on the DIVAD gun system that was recently canceled? Precisely how much profit or loss?

Ms. Spector. The actual profit or loss realized by Ford Aerospace on the DIVAD program can not be precisely determined until a termination settlement has been negotiated between the contractor and the government. The process for settling terminated contracts is lengthy, because it involves proposal submission by the contractor, audit by the Defense Contract Audit Agency, and negotiation by the contracting officer. To date, this process has not progressed far enough to furnish any projections on profit or loss.

Question 1D. What is the profit level on the M1 Abrams tank?

Ms. Spector. According to the Army, final costs on the Fiscal Year (FY) 1979 contract have not yet been settled; therefore, actual profits cannot be determined at this time. On the FY 1980 contract, there was a dispute between the Army and the contractor, with the parties finally agreeing to a cost reimbursement contract with a cost ceiling. The contractor exceeded this ceiling and therefore, earned no profit for this particular procurement. For FY 1981 to FY 1985, the contracts were negotiated on a firm-fixed price basis. This type of contract has no reporting provision that requires contractors to provide the government with actual earned profit. Therefore, the Army does not know exactly what profit levels the contractor actually earned on the M1 Abrams tank.

Question 1E. When the Navy buys the Orion airplane (the P-3), what is the profit level?

Ms. Spector. The Fiscal Year (FY) 1981 through 1985 contracts for the P-3C Orion were negotiated on a firm fixed price basis. The Navy does not possess information which shows the final profit earned by the company. The negotiated profits reflected in the Navy's internal negotiation memoranda, for purchases of the P-3C were as follows:

Fiscal year:	*Aircraft*
1981, 12.0	16
1982, 12.1	16
1983, 13.1	13
1984, 12.85	11
1985, 12.56	9

It must be stressed that these profit rates do not consider the unallowable costs that must be absorbed by the contractor.

Question 1F. Defense procedures include a negotiated profit. This is what the Department refers to as "apparent profit." Can it determine with any precision what "real profit" is on any given contract? Was the Renegotiation Board able to determine real profit levels?

Ms. Spector. There are two principal differences between apparent contract profit (pre-performance) and real contract profit (post-performance). First, there are many costs incurred in the performance of defense contracts which are not allowable under the Federal Acquisition Regulation. Examples include: interest expenses, over ceiling independent research and development/bid and proposal expenses, advertising expenses, and charitable contributions. These costs must, therefore, be paid from the gross profits earned on the contract. Second, there are the normal variances in cost behavior that would be experienced during contract performance. These could be caused by many factors including better than expected performance, variance with planning assumptions, or technical considerations.

There is no current requirement for contractors to report real profits earned on defense contracts. We do, however, routinely collect what the apparent profit or markup is on each negotiated contract in excess of $500,000. Furthermore, for incentive type contracts, the contractor must submit a cost report to the contracting officer for determining final cost and profit, but this is without consideration to unallowable costs. The Department also periodically performs an industry-wide assessment of profits, including actual profits. The most recent study was the "Defense Financial and Investment Review" (DFAIR) which was released August 1985. A copy of this study has already been sent to this Committee.

The Renegotiation Board evaluated profit on a corporate-wide basis and not on a contract-by-contract basis. It is, therefore, doubtful that the Board could have determined real profit levels of individual defense contracts with any exactness.

COST ACCOUNTING STANDARDS

Question 2A. Please clarify exactly how the Cost Accounting Standards Board functioned.

Ms. Spector. The Cost Accounting Standards Board consisted of five members and was chaired by the Comptroller General. The Board was authorized to promulgate Cost Accounting Standards and to make, promulgate, amend, and rescind rules and regulations for implementing these standards. The standards were designed to achieve uniformity and consistency in the cost accounting principles followed by defense contractors and subcontractors.

To carry out its general duty of promulgating Cost Accounting Standards, as well as implementing rules and regulations, the Board employed a staff (15 to 20 people) of administrative and technical specialists. The staff advised the Board and performed most of the technical effort in the development of Cost Accounting Standards, rules, and regulations.

Proposed rules, regulations, or Cost Accounting Standards were published for comment in the Federal Register. Normally, all parties affected were given 30 days to submit comments on the proposal to the Board. After reviewing the comments, the Board published a final version of the standard, rule, or regulation in the Federal Register.

Congress had a sixty day period to review the final version of the standards, rules, or regulations. If Congress did not pass concurrent resolution objecting to the proposed standard, rule, or regulation, it became effective. Thus, Cost Accounting Standard Board promulgations had the full force and effect of law.

Question 2B. Uniform Cost Accounting Standards are critical to the determination of costs and profits. The Cost Accounting Standards Board went out of existence in 1980. How are the standards revised and updated? Have they been revised and updated?

Ms. Spector. The Cost Accounting Standards issued by the Cost Accounting Standards Board have not been revised or updated since the Board went out of existence in 1980.

Question 2C. OMB claims that the Department of Defense can revise the Cost Accounting Standards. Is that being done? When will any revised standards be issued?

Ms. Spector. Based on a Department of Justice legal opinion, the Department of Defense has the authority to revise the Cost Accounting Standards. The Department will exercise this authority through the Federal Acquisition Regulatory process.

The necessary Federal Acquisition Regulation changes enabling the Department to assume Cost Accounting Standards Board responsibilities were approved by the Defense Acquisition Regulatory Council in October 1985 and were forwarded to the Civilian Acquisition Agency Council for review in accordance with formal procedures. In addition, the Department has established the Cost Accounting Standards Policy Group to be responsible for developing procedures to modify, rescind or deviate from existing standards, and develop new standards. The Cost Accounting Standards Policy Group is reviewing the standards and will issue any proposed revisions through the Federal Acquisition Regulation process.

Question 2D. When the Department of Defense does issue revised Cost Accounting Standards, its right to do so will certainly be challenged in court. Rather than have a long and costly litigation, doesn't it make more sense just to reconstitute the Cost Accounting Standards Board?

Ms. Spector. The Department of Defense has the legal ability to assume Cost Accounting Standard authority. The Department of Justice has stated that DoD is legally free to adopt, reject, or grant exemptions to the Cost Accounting Standards. In our opinion, fear of litigation is not a compelling reason to reconstitute the Cost Accounting Standards Board.

Question 2E. What kind of problems would such a challenge pose for the Department of Defense?

Ms. SPECTOR. While litigation may delay implementation of revised Cost Accounting Standards, we do not believe litigation will create significant problems for the Department of Defense.

DEFECTIVE PRICING

QUESTION 3A. What exactly is defective pricing?

Ms. SPECTOR. The Truth in Negotiations Act requires cost or pricing data to be current, accurate, and complete. If all three conditions are not met at the time of contract award, and the contracting officer relied on the data to establish price, then the data is defective and the government is entitled to a retroactive price adjustment.

QUESTION 3B. In the case of the $200 stool cap: was this defective pricing, fraud or sheer human folly?

Ms. SPECTOR. It was not defective pricing. It was a mistake in the method of procurement. The fundamental problem with the stool cap was that it was over-engineered. Over 20 separate tooling steps were required to manufacture a single cap, and the process began with machining a solid block of teflon.

As a broad concern, the Department recognized that its spare parts pricing and acquisition processes needed improvement. Many initiatives have been undertaken within the Department to correct the systems deficiencies which caused situations such as this.

QUESTION 3C. In the case of the $400 hammer and the high-priced tool kit: would this represent defective pricing, fraud, or an overhead accounting system run amok?

Ms. SPECTOR. No, the $400 was a mistake in the method of procurement which the Department has corrected. It is also important to note that while we did pay $400 for a hammer and subsequently received a voluntary refund from the contractor, we bought 87,000 hammers at $8.00 apiece. This is about $4.00 less than the local hardware store price.

Again, rather than dwell on individual spare parts pricing problems, we believe it would be very helpful to focus on the broad initiatives that have been undertaken by the Department. Furthermore, a Renegotiation Board, per se, would not have likely resulted in findings of excessive profits for these contractors, even by product line. This is because they tend to be isolated cases and would not influence total profits.

QUESTION 3D. When there is an excessive price charged because of defective pricing, the Department of Defense can reduce the price by its own unilateral action. How many such cases are there so far this year? What amounts have been involved? Could you cite some specific cases?

Ms. SPECTOR. According to statistics maintained by the Defense Contract Audit Agency, there were 1,643 defective pricing reviews completed between July 1, 1984, and June 30, 1985. The results of these reviews were presented to the contracting officers for action. The process for resolving defective pricing cases normally allows the contractor to supply an explanation, additional information, rebuttal, etc. Then the contracting officer, using advice and assistance from the contract auditor, attempts to reach a bilateral agreement with the contractor on the appropriate price reduction. If no bilateral agreement is achievable, unilateral action may be taken by the contracting officer. During the July 1, 1984 and June 30, 1985 period, $127.9 million in defective pricing cases were sustained by the contracting officer, both through bilateral agreements and unilaterally. Some examples of defective pricing cases follow:

The Army sustained a $693,625 price reduction on the TOW missile program. The contractor had miscalculated the business base for computing overhead rates and had not updated subcontract costs. The contractor agreed to the reduction.

The Navy sustained a $422,843 price reduction on the AV-8B aircraft program. Travel costs furnished by the contractor were found to be defective. The contractor agreed to the adjustment.

The Air Force sustained an $84,169 price reduction for J-75 engine parts. The contractor volunteered to the contracting officer that they failed to disclose at the time of price negotiations the latest vendor price quotations and variance standards for material. The contract price was reduced.

QUESTION 3E. If a contract price is clearly out of line, even though the pricing formula and overhead data are correct, what can the Department do? Suppose you discover that a manufacturing breakthrough dramatically reduces the cost of production. Can you renegotiate the contract? Or suppose that there has been a sudden drop in the price of materials, leading to less than expected production costs. Can you renegotiate?

Ms. Spector. The action available to the government on the instant contract as a result of such circumstances would largely depend upon the type of contract. On a firm-fixed price contract, there would be no change in price. On a cost type contract, all savings would accrue to the government. For all contract types in between such as fixed-price incentive contracts, the government's share in cost savings of this nature would depend upon the contracts' government/contractor share ratio. The real savings to the government would show up in the reduced prices of follow-on work. That is why we encourage contractors to pursue manufacturing breakthough or lower costing material.

The government cannot renegotiate the contract price for the circumstances described, just as prices are not increased under reversed circumstances. It should also be noted that the Renegotiation Board's subjective criteria for evaluating excessive profit, probably would have not resulted in renegotiation for manufacturing breakthroughs or drop in material prices.

Question 3F. Does the Department of Defense have full access to contractor pricing and cost data? For instance, when profitability reports are done, like the 1985 DFAIR study, is any of that material audited by you or anybody else? How do you know that the profit data you are getting is accurate?

Ms. Spector. Yes. Both Truth in Negotiations Act and the Federal Acquisition Regulation require the prime contractor or subcontractor to submit cost or pricing data for most negotiated contracts in excess of $100,000.

DFAIR financial data was audited by independent CPA firms of the individual participating contractors and was accumulated by Touche Ross, Incorporated, another independent CPA firm. DFAIR's use of independent CPA firms in the reporting and accumulation of financial data provided reasonable assurances to users of the DFAIR report that the data was accurate.

Questions Submitted by Congressman Gonzalez to Mr. Math With Attached Responses

1. Why should a profit study be an adequate substitute for the Renegotiation Board?

Answer. We believe that a system which provides for regular periodic profit studies based on data mandatorily submitted is preferable to reestablishing a renegotiation board because:

1. A renegotiating board takes back profits negotiated and, in the view of the contractor, properly earned. A profit policy based on regular and mandatory reporting could be designed to provide confidence that the policy is providing contractors with an appropriate level of profits in the first place.

2. The data which we envision that would be submitted under a periodic profit reporting system would be similar to that which a renegotiation board would require contractors to file. However, our suggested system would use this data for a prospective, forward-looking approach to adjusting contractor profit.

1a. Who would perform such a study?

Answer. The required data would be submitted to appropriate procurement agencies. The studies would be performed by each agency and would be made based on data developed from the mandatory profitability reporting program. DOD would be responsible for conducting the studies pertaining to defense contractos. These studies would require annual reporting of profitability by contractor segments engaged in government work.

The reports would be reconcilable to the corporate financial statements and would be reviewed by the company's certified public accounting firm. Once operational, this reporting system would yield reliable information on the profitability of government contracts which would make meaningful periodic studies possible.

1b. How often would the studies be performed?

Answer. We believe the studies should be performed at least every 3 years.

1c. What would be done with these studies?

Answer. The periodic studies would provide the information necessary to guide overall agency profit policy. The studies would allow the agency to make continuing adjustments to its profit policy on a regular basis rather than making major changes every 10 years.

1d. Would the studies be performed on a contract-by-contract basis or on an aggregate basis?

Answer. The studies would analyze profitability by division or segment of a company, depending on the type or class of product or product line that segment of the company provides to the government. For example, if a company has an aircraft division and a shipbuilding division, a separate report would be made for each division. We recommend that the agency precribe by regulation the types of classes of products or product lines for which profit studies would be made. To the extent practicable, we suggest that the segregation of product lines prescribed in the regulations reflect the identification of product lines contained in the Form 10-K annual reports which companies must file with the Securities and Exchange Commission pursuant to section 13 of the Securities Exchange Act of 1934, 15 U.S.C. § 78m, and implementing regulations.

1e. How would the defense industry be held accountable for any excessive profits determined as a result of the study?

Answer. We propose these periodic studies to be prospective in nature. That is, they would be used to project what DOD profit policy should be in the future. Therefore, if DOD determined that contractors in one areas of defense business are making excessive profits, it will change DOD profit policy to insure that excessive profits are not awarded in the future.

QUESTIONS SUBMITTED BY CONGRESSMAN GONZALEZ TO MR. KAUFMAN WITH ATTACHED RESPONSES.

Question 1. We are told that renegotiation has a perverse effect; that it would create disincentives for developing economic efficiency or developing more efficient technologies. How do you respond to this argument?

Answer. The Renegotiation Act declares that sound execution of the national defense program requires the elimination of excessive profits from defense contracts. The act sets out the factors that should be considered when determining whether profits are excessive. Among the factors are: (1) reasonableness of costs and profits, with particular regard to the volume of production and normal earnings; (2) the amount and source of public and private capital employed; (3) the risk assumed; (4) the contribution to the defense effort; and (5) the character of the business.

It can be seen that the intent of the law was to strike a balance between the need for contractors to make a reasonable profit and the need of the government to achieve economy in the defense program. There is no contradiction between the two objectives. Defense contractors should be able to achieve efficiency and technological advances while earning reasonable profits. To argue that placing reasonable limits on defense profits would stifle cost controls and technical innovation requires an assumption that defense contractors must be able to gouge the government in order to perform well. No convincing evidence has been brought forward to support this view.

Question 2. The Department of Defense claims that the Renegotiation Board was not cost effective. Do you agree with this analysis? Please explain.

Answer. The Renegotiation Board invariably achieved reductions of profits in amounts that greatly exceeded the direct costs of the Board. Some critics argue that defense contractors had large indirect costs in complying with the Board's regulations. The GAO investigated a number of such allegations and were unable to substantiate them. A copy of the GAO report has been submitted to the Subcommittee for the record.

Question 3. In studies like DFAIR, should the Department of Defense seek data on individual contractors and contract profitability, or is it sufficient to rely on aggregated, screened data? Why?

Answer. There are several approaches to determine profitability. One approach, used in the DFAIR study, is for information to be submitted voluntarily by the contractors and screened by an outside group before being analyzed by government officials. A weakness of this approach is that the data base will not include contractors who chose not to submit information, and their profits may differ from those who do. A problem with the screening process is that it introduces an element of doubt into the picture because analysts are prevented from seeing the data in its original form. Also, it would not be possible for government auditors to verify the results of the study unless the raw data were made available for examination.

Another approach is to obtain profit data from financial reports filed with the Securities and Exchange Commission. Use of this information does not require permission from contractors and, as the reports are public, there is no need for the profit data to be screened. This approach was used by the Navy in a study of major defense contractors issued August 20, 1985. This study found that profits on defense contracts are much higher than on commercial work. A copy of the introduction to the study, entitled "Financial Analysis of Major Defense Contractors," is attached to this response and I ask that it be included in the record of the hearings.

A third approach would be require contractors to report their realized profits to the Defense Department. This would enable the Defense Department to analyze profit data on a regular, comprehensive basis without resorting to outside consultants or screening devices. Committees of Congress could exercise their defense profits policy oversight responsibilities if the Defense Department made available periodic profits reports based on the information submitted by contractors. This approach is preferable to those described above but it may be useful to supplement it with the results of questionnaires, SEC-type financial data, or other sources of information.

FINANCIAL ANALYSIS OF MAJOR DEFENSE CONTRACTORS

20 AUGUST 1985

PREPARED FOR THE ASSISTANT SECRETARY OF THE NAVY
(SHIPBUILDING AND LOGISTICS)
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by

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FINANCIAL ANALYSIS OF MAJOR DEFENSE CONTRACTORS

Introduction

This Report provides financial data and analysis of Major Defense Contractors using as the source the latest Annual Report (and Form 10-K) of the individual companies, plus earlier year reports for prior years' data. It provides an update and expansion of the similar report published in July 1984, Financial Analysis of Major Defense Contractors. This year's report updates the data and analysis by: (1) adding 1984 financial results for the firms; (2) adding two corporations, Textron and Martin-Marietta, to the 20 analyzed in the 1984 report and (3) developing composite ROA and ROS figures, in addition to the individual annual figures for each firm, to enable comparison of financial results, for 1977 through 1984, in U.S. Government (USG) 1/ and commercial markets for the 22 corporations analyzed.

RRG Associates has been conducting economic/financial analysis for the Navy for the past few years. The first report

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1/ The paper uses the term USG for reasons of accuracy. Most of the sales are to the DOD (the Services specifically) but often there is a relatively minor portion of sales by the same corporate segment to NASA or Foreign Military Sales (FMS) through DOD. Therefore, the term USG is used vice DOD.

covered a few companies and covered data back to 1977. In subsequent years, as the utility of such analysis was manifest, the data was updated, the list of companies was expanded, and the depth of analysis increased.

The purpose of the sort of economic/financial analysis embodied in this report was initially to provide the Navy with basic financial intelligence on the major defense hardware contractors. The need for, and utility of, such organized data and basic analysis should be obvious. Basically, an understanding of the finances and financial events of the segments and the total corporation provided Navy decision makers with one sort of information, to compliment information of various other sorts, in making decisions on specific programs/contracts and in dealing with specific corporations. The bottom-line purpose of this analysis and further analyses based on data and results presented here, is to provide tools useful in the process of controlling costs of Navy systems and in developing and applying procurement policies and practices.

The raw data used in the analysis is included in this report so as to be available for use by the reader in fashioning other tables or graphs to suit other needs, issues or applications.

This analysis should be viewed more as macro analysis of trends and financial results of the firms who are the Major Defense Contractors, than as a micro analysis of any one firm. The annual reports (and Form 10-K's) of the individual firms formed the data source and even macro analysis must deal with and address the individual firms; however, care should be taken in drawing any conclusions about individual firms from this macro analysis. The firms are not consistent in their manner of reporting and do not all define terms precisely the same way.

Besides being major USG contractors these firms represent a major amount of business in a variety of commercial markets. In 1984, about 50% of the sales of the 22 corporations, collectively, were in a variety of commercial markets. In addition to a meaningful comparison of USG/Commercial profitability, such comparisons of USG and commercial business within the same set of major defense contractors are of interest because of the influence on corporate decisions, especially capital investment decisions, the confluence of segment cash flow streams at the corporate level and the redistribution of cash for capital investment within the corporation. Such a USG/Commercial breakout is not totally simple or straight-forward. While all of the firms (except one) breakout their total business into two or more segments for purposes of financial reporting, in several cases some individual segments (the finest structure at which sales, operating earnings, identifiable assets and new investments are reported in publicly available reports) for a given firm contain a mixture of significant elements of both USG and commercial business and this limits the ability to clearly contrast USG and commercial business for such segments. Several of the almost-all-USG segments also have small amounts of sales in commercial markets, for example, Grumman Aerospace segment has about 10% of its sales as a subcontractor to a commercial program and 5% of Northrop's sales are generated as a subcontractor for a commercial airliner. The segments identified as commercial and used in computations make commercial products for industrial or consumer markets, and with only minor exceptions, are all commercial sales. Segments making commercial products with significant sales to the USG, such as Sperry's commercial computer system where about 20% of sales are to the USG, are not used in the summary calculations. Data for all segments, USG, commercial and mixed is shown in the detailed tables for each company. In most cases, however, the segments do contain a relatively pure set of either USG or commercial business, thus readily enabling direct comparisons. The major exceptions are discussed as appropriate.

It should also be noted that when the analysis is dealing with segment level data on profits, those profits are gross of interest expenses (or income) and taxes [2] and corporate level expenses, which are treated in the reports as corporate-level items [3]. The segment operating profits more clearly reflect the actual operations of the individual segments and the interaction with the USG and commercial markets, the primary interest in this report. Since the profit figures for both USG and commercial business are both gross of corporate level expenses, corporate taxes and interest, meaningful comparision between USG and commercial profitability can be legitimately made. Significant and comparable amounts of USG as distinct from commercial business could be broken out to develop composite figures for comparisons of relative profitability of USG and commercial business. Figures for corporate level profitability which reflect all business of the corporation combined, and are net of corporate level items, taxes and interest, are provided in the data tables for each firm.

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[2] Because the USG finances more of the work and because taxes on income reported on USG business in the annual reports are often deferred until contract completion, inclusion of these 2 factors, if they could be included, would likely raise profitability measures on USG work relative to commercial business.

[3] 17 of the 22 corporations analyzed report their data this way, 4 report somewhat differently and 1 has no separate segments. An example of one of the firms that does things a little differently than the others is one which subtracts its R&D expenses after combining segment results without showing how the R&D was allocated among segments.

The report is organized as follows: (1) The next section provides summary results for the 22 corporations, individually and collectively, and analysis of some broad issues that the basic analysis suggests and supports; (2) the section that follows that one provides a historical and current perspective on relative profitability and explores some of the likely causes for observed differences and changes and (3) the final section contains a several-page financial data package on each company covering individual segment and corporate-wide financial information. Again all raw data was extracted from audited annual reports (and form 10-K's) published openly by the corporations.

The Corporations whose financial data for 1984 and prior years is covered in this report are:

BOEING
FMC
GENERAL DYANMICS
GENERAL ELECTRIC
GRUMMAN
HONEYWELL
LITTON
LOCKHEED
MARTIN-MARIETTA
MCDONNELL-DOUGLAS
MORRISON-KNUDSON (NASSCO)
NORTHROP
OGDEN (AVONDALE)
RAYTHEON
RCA
ROCKWELL
SPERRY
TENNECO
TEXAS INTRUMENTS
TEXTRON (BELL)
TODD SHIPYARDS
UNITED TECHNOLOGIES

Summary and Analysis of Broad Issues

Table I shows summary data on each company for 1984. The first column shows the percent of each corporation's sales for 1984 that were to the USG. As the table shows, the range is from Newport News Shipbuilding, perhaps the most important Navy shipbuilder, at only 12.2% of Tenneco's sales, to Todd, Grumman, Martin-Marietta, Northrop, Lockheed and General Dynamics where sales to the USG are 80% or more of total corporate sales. In general, since 1977, sales to the USG are an increasing percentage of the total sales of the corporations examined. For example, 3 years ago Newport News Shipbuilding was only about 6% of Tenneco's sales. For 1984, specifically, compared to 1983, Boeing and Morrison-Knudson show a substantial increase in the share of total sales volume coming from USG business (from 37% USG to 43% USG for Boeing and from 14% to 22% for Morrison-Knudson). For both corporations the cause was a combination of increasing USG sales and decreasing commercial sales. Ten of the corporations showed slight increases in the USG share and 5 showed essentially no change. Only 5 of the 22 showed even a slight decrease (5-10%) [4] in the USG share of total sales.

The second column of Table I shows the percentage that profits from sales to the USG are of total profits for 1984. As noted earlier, a few corporations have one or more segments that have a combination of commercial and USG business and, therefore,

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[4] The change in the USG percentage was 5-10% of 1983 figures: the change was not 5-10 percentage points.

TABLE I

FINANCIAL ANALYSIS OF 22 OF THE MAJOR DEFENSE CONTRACTORS
SUMMARY OF SELECTED DATA FOR 1984

COMPANY	% OF SALES TO USG 1/	% OF TOTAL PROFITS 2/ FROM USG SEGMENTS	ROA 3/ FOR USG SEGMENT(S)
BOEING	41.8%	93.7%	29.3%
FMC	42.4	48.5	53.6
GENERAL DYNAMICS 4/	89.8	96.7+	35.5
GENERAL ELECTRIC	20.0	5/	5/
GRUMMAN	81.9	87.1	19.7
HONEYWELL	23.6	20.3 6/	14.5 6/
LITTON	41.0	5/ 7/	5/ 7/
LOCKHEED	85.0 8/	94.5-	22.0
MARTIN-MARIETTA	80.5	70.9	35.0
MCDONNELL-DOUGLAS	68.7+	97.8+	26.9
MORRISON-KNUDSON (NASSCO)	17.6-	5/	5/
NORTHROP	84.2	93.3+	19.6 9/
OGDEN (AVONDALE) 10/	19.7-	26.4-	5/
RAYTHEON	49.3	79.1-	25.4 11/
RCA	14.3	16.9	23.7
ROCKWELL 12/	62.7	58.9+	29.4
SPERRY	44.0	5/	13/
TENNECO	12.2	14.6	30.0
TEXAS INSTRUMENTS	24.2	24.3/32.7 14/	23.1
TEXTRON (BELL)	23.0	5/	5/
TODD SHIPYARDS	82.6	5/	9.1 15/
UNITED TECHNOLOGIES	29.0	5/	18.2 16/

COMPOSITE ROA FOR $80B OF SALES BY THESE COMPANIES IN VARIOUS COMMERCIAL MARKETS	10.7
COMPOSITE ROA FOR THESE COMPANIES IN BUSINESS WHERE PRODUCTS ARE SIMILAR TO USG BUSINESS PRODUCTS	11.3

1/ Sales to United States Government, primarily sales to DOD; however, sales to NASA, other USG agencies and, in a few cases, sales direct to foreign governments, are included.

2/ Operating Profits of Manufacturing/Industrial Segments.

3/ Operating Profits divided by Identifiable Assets of Operating Segment(s). Segments used in calculation are either all USG or predominately (very) USG.

4/ Includes data for Quincy Shipbuilding Division, which, for 1984, consisted of construction of MPS ships built for a GD subsidiary which will charter the ships to the Navy (Military Sealift Command). Quincy's data (about 5% of GD's total sales) are counted as sales to the USG here. If those sales are not counted in 1984, sales to USG come to 85.6% vice 89.8% of GD total sales and profits from USG sales are 89.2% of total GD operating profit.

5/ No breakout of USG business in separate segments, therefore not possible to obtain profits or asset figures for USG business as distinct from commercial business.

6/ Based on results in aerospace and defense segments, where 66.6% of sales were to USG in 1984. Profits and assets data are, of course, for USG and non-USG sales within that segment since the segment is the lowest level on which data is published by Honeywell. This estimating technique assumes that profits and assets are apportioned between USG and commercial products based on the 2/3 USG; 1/3 commercial ratio of sales. The ROA figures shown here are almost certainly lower then the true USG ROA figures.

7/ USG electronics sales are comingled with commercial sales in two Littor segments; Ingalls Shipbuilding sales are almost all to USG. Ingalls alone accounted for 18% of sales, 20% of profits and had an ROA of 76.3%, in 1984. In 1983 the Ingalls ROA was 69.3%.

8/ Plus 9.8% more to foreign government.

9/ Northrop's ROA is not reflective of ROA on current USG contracts because of the F-20 on which the company has spent $774M to date but has not yet produced any sales or profits. See Table II and III for further discussion.

10/ Figures are for Ogden's Marine and Modular Construction segment which includes an unspecified amount of commerical business in addition to USN business at Avondale.

11/ Figures are based on Raytheon's electronics segment. The majority of whose sales are estimated to be to the USG.

12/ Rockwell's Aerospace segments's sales are almost (99%) all to the USG. And 72% of all Rockwell sales to the USG are in this Aerospace Segment. However, sales to the USG are only 32% of the sales of the other Rockwell segments which also have some sales to the USG. The published data does not allow a break-out of profits from USG business from the total profit figures reported for the segments nor the portion of reported segment assets used in USG business. The figure for % of total profits that come from USG business includes an estimate of profits derived from USG business in the 3 mixed segments plus the profits from the pure USG aerospace segment. The ROA figure is for the aerospace segment alone.

13/ Sperry reports USG business in 2 segments, both of which include non-USG sales as well. Therefore, it is not possible to clearly break-out an ROA for USG business. However, the ROA's appear to vary with percent of USG business in a segment as follows:

SEGMENT	% OF SALES TO USG	SEGMENT ROA
Farm Equipment	0%	6.9%
Commercial Computer Systems	19.8	10.6
Defense and Aerospace Systems	74.8	17.8

14/ Due to a technical complication in the way TI reports total profit, it is not possible to compute this one number for TI in the same way as it is computed for other corporations. The actual figure for percentage of derived from direct and indirect sales to the USG is somewhere between these two numbers.

15/ Todd reports for the corporation overall; no segments are reported. Therefore, no operating segment identifiable asset figure is provided by Todd with which to calculate ROA. An estimate can be developed from the Todd balance sheet and this was done for both Table I and III. See the detailed section of Todd later in this report for further discussion.

16/ ROA figures are for Flight Systems segment of United Technologies where 75% of sales are to USG.

it is not possible, given the data structure of the annual report of such a corporation, to as clearly separate the operating profits or asset figures reported for the total corporation as between those derived from or used in USG business and those from commercial business. General Electric is a clear example. Complete data is presented for the Aircraft Engine and Spares Segment at GE, but it is clear that that segment includes both military and commercial engines and no further breakdown is provided by GE. All of this is to explain the footnote 5/entry rather than a number on Table I for a few of the firms. For some of even these few corporations, more than one segment includes USG business and some of those segments are clearly all USG business, so that in later tables in this report, when individual segment ROS and ROA's are displayed, sound numbers are obtainable and presented even though corporate total USG profit figures are not shown here in Table I. Litton is an example. No figure is provided in column 2 (or 3) of Table I for Litton because the Advanced Electronics Segment includes both USG and commercial sales (an estimated 51% USG) and the reported operating profit for that segment does not separately report operating profits for USG and commercial business. However, the Litton Shipbuilding Segment, Marine Engineering and Production, is almost all USG business, so in later tables where data is reported by segment, reliable figures for the Shipbuilding part of Litton can be and are presented. GE, United Technologies and Textron are the 3 major corporations where no single segment is all USG and can be isolated. But even these three corporations have other segments that are all commercial and these are used in the commercial data base. These three corporations have only a small part (20-30%) of their total sales to the USG, in any event.

In several cases, the share of profits from sales to the USG is larger than the share of total sales to the USG, indicating higher profit rates (Return on Sales (ROS)) from government business as compared to sales in the commercial markets. The relative ROS's and the relative Return on Assets (ROA's) will be discussed further in connection with subsequent tables. However, the numbers in column 2 also indicate the degree to which each corporation is dependent on the USG for profits and for its financial vitality and viability. The data shows that in 1984, 5 of the corporations, Boeing, General Dynamics, Lockheed, McDonnell-Douglas and Northrop clearly rely on USG business for 90% or more of their operating profits and Grumman is very close at about 87% and Todd is probably at 90% or more, although Todd's limited data breakout prevents an exact number. Probably about 11 [5] of the 22 derive 50% or more of their total operating profits from USG business in 1984 and FMC is at 48.5%. In some cases, the profits from USG programs have effectively offset the corporation's efforts in commercial markets where the Corporations continue to achieve operating losses.

The third column shows the overall Return on Assets (ROA) for all USG programs at each of the corporations. The operating profit figures used here as the Returns part of ROA are segment

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5/ The 9 shown in the table plus Todd and Litton.

figures, gross of interest income or costs and taxes and corporate level expenses, for both USG and commercial segments. Therefore, they are useful relative estimates of the segments' operating results, but not valid measures of net, final corporate return on assets or equity. A variety of corporate financial practices and events not associated with current operations of the segments affect the corporations net bottom line figures. Final Corporate-Level numbers for each corporation are included in the data set for each corporation that follow in this paper.

Table II shows Return on Sales (ROS), defined as operating profit divided by sales, for 1984 back to 1980. On the first page, ROS for USG business only is shown and the firms are broken down into four major industries, Aerospace, Shipbuilding, Electronics and Ordnance. Some firms have segments in more than one industry, (e.g., General Dynamics Government Aerospace, General Dynamics Government Shipbuilding and General Dynamics Land Systems (Tanks)) and such a firm will appear more than once. Table II indicates by footnote 2/, those segments where a clear break-out of USG and commercial work cannot be derived from the Corporate Financial Reports. Again the noteworthy cases are GE (both Aircraft Engines and Electronics), United Technologies (Flight Systems (including Sikorsky) and Power Systems (Pratt and Whitney)) and Textron (Bell military and commercial helicopters). Other individual segments denoted by footnote 2 are known to involve mostly USG sales (Todd Shipbuilding (82.6%), Sperry Electronics (75% USG), Litton (Advanced Electronics Systems) and Rockwell Electronics Segment (57% USG)).

TABLE II

COMPARATIVE RETURN ON SALES (ROS[1]) Government Sector

U.S. GOVERNMENT	1984	1983	1982	1981	1980
Aerospace(A/C,Eng,Miss,etc)					
Boeing	10.7	10.5	11.0	11.0	7.3
General Dynamics	10.3	10.0	9.6	8.2	6.9
General Electric[2]	13.7	11.7	11.1	11.1	10.5
Grumman	7.2	8.1	9.4	10.4	8.2
Honeywell	7.2	7.1	6.9	7.0	6.2
Lockheed	8.2	7.9	8.1	8.8	7.6
Martin-Marietta	7.8	8.0	7.0		
McDonnell Douglas	7.7	7.4	6.8	7.2	7.3
Northrop[3]	8.9	6.2	(3.5)	1.7	8.6
Rockwell	9.1	9.1	8.1	8.9	5.5
Textron[2]	6.2	7.6	8.2		
United Technology[2]	7.2	8.5	8.5	6.4	5.4
Shipbuilding					
General Dynamics	10.4	6.2	( )	( )	2.6
Litton/Ingalls	10.3	11.2	9.3	11.4	16.1
Lockheed	5.3	11.1	9.0	11.7	11.6
NASSCO	15.2	18.3	12.0	6.3	8.1
Avondale	5.7	9.3	2.2	1.8	(1.6)
Newport News	12.8	10.0	9.1	8.1	6.9
Todd	5.7	4.5	5.0	6.2	4.4
Electronics					
General Electric[2]	10.8	7.6	5.6	6.6	7.6
Littor[2]	10.3	10.1	10.6	8.5	10.4
Northrop	11.7	11.5	10.3	12.2	11.1
Raytheon	12.7	12.9	12.0		
RCA	7.3	7.4	7.6	7.3	6.6
Rockwell[2]	9.2	8.9	9.2	6.3	9.3
Sperry[2]	8.3	9.2	8.7		
Texas Instruments	11.4	14.6	15.2	15.4	11.9
Ordnance/Land Systems					
FMC	13.5	9.9	8.2	9.1	12.6
General Dynamics	3.9	3.3	2.3		
Compcsite ROS for all USG segments above	9.2				
Composite ROS for mixed USG/Commercial segments above (denoted by [2])	9.3				
Composite ROS for $80B of Commercial Sales (see next page)	8.0				
Composite ROS for selected commercial segments (see next page)	7.7				

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[1] Operating profits divided by sales of the segment(s).

[2] At these corporations, the segment(s) that include the USG business also include commercial business and it is not possible, given the data sources, to separate profits from USG business from profits from commercial business within the segment. The same is true of identifiable assets. Therefore, the ROS/ROA figures shown here are the figures for the entire segment which includes USG business rather than for USG business *per se.*

[3] The figures shown above for Northrop Aerospace are based on profit figures that are calculated by Northrop by subtracting F-20 costs from achieved profits on programs that have/are achieving sales. F-20 expenses total some $774M through 1984. ROS's computed based on operating profits on aircraft programs whose sales generated those operating profits, without subtracting F-20 expenses, are: 1984 - 13.7; 1983 - 12.1; 1982 - 9.8; 1981 - 8.0; 1980 - 8.5.

TABLE II (continued)

COMMERCIAL SECTOR ROS (COVERS APP. $80B SALES IN 1984)

Industry (Company)	1984	1983	1982	1981	1980
Food Products (Ogden)	2.8	2.6	1.7	4.1	4.4
Oil, gas & chem (Tenneco)	13.6	15.4	17.5	17.9	17.2
Indust. chem (FMC)	18.2	16.8	15.4	14.9	13.5
Perform. chem (FMC)	10.6	6.0	3.0	12.4	(0.6)
Energy (Raytheon)	2.1	1.8	5.8	7.5	6.6
Constr. & Engr. (M&K)	4.3	3.6	4.7	6.1	5.7
Constr. (Northrop)	Discon.	(164.3)	(1.0)	5.2	16.7
*Bldg. Sys. (U.T.)	5.0	6.9	7.0	7.6	9.1
*Indust. Prod. (U.T)	7.8	5.1	1.4	1.4	8.3
*Gen. Indust. (Rockwell)	10.7	8.9	9.6	14.6	10.0
*Spl. Mach. (FMC)	6.3	(2.5)	(5.7)	(0.6)	1.8
*Metallur. Mater. (T.I.)	8.6	15.1	8.8	13.0	19.6
*Power Sys (G.E.)	13.6	13.0	10.6	7.7	6.6
*Elect. & Electron. Prod. (Litton)	8.7	8.6	9.3	10.1	9.8
*Control Prod (Honeywell)	13.8	4.1	7.8	8.4	12.8
*Control Sys. (Honeywell)	8.4	8.6	11.5	11.6	11.1
*Electron. Comp. (T.I.)	19.4	13.9	2.5	1.8	14.9
*Info. Sys. (Honeywell)	9.9	7.9	4.8	8.9	11.3
Business Sys (Litton)	Discon.	(1.9)	--	4.2	5.3
*Digital Prod. (T.I.)	0.0	(66.0)	2.0	2.4	6.5
*Commer. & Consum. Prod. (RCA)	3.1	3.0	3.6	2.4	6.1
*Consum. Prod. (GE)	11.8	9.6	7.5	8.4	9.9
*Appliances (Raytheon)	7.7	7.5	3.9	4.2	3.1
*Commercial A/C (Boeing)	0.0	1.4	0.3	4.4	8.9
*Trans. Acft. (MDC)	2.7	(2.3)	(3.1)	(3.5)	(6.5)
*Automotive (Rockwell)	12.2	3.7	3.6	1.2	5.4
Transportation (RCA)	3.5	5.0	5.1	3.0	9.9
Communications (RCA)	25.7	24.7	44.8	30.7	35.8
Broadcasting (RCA)	9.2	[illegible].5	6.0	3.0	4.9
Services (FMC)	(9.3)	(3.3)	15.9	20.3	17.4
Services (GE)	5.1	17.7	23.9	24.2	24.1
Services (Litton)	8.5	8.5	16.1	17.0	18.1
Services (Ogden)	5.5	5.2	5.7	5.7	4.1
Services (T.I.)	(8.6)	5.0	12.9	18.3	14.6
*Automotive (Tenneco)	15.3	12.7	10.4	7.7	4.8
*Basic Prod. (Martin Marietta)	20.1	18.2	4.2		
Information Sys (MDC)	(5.1)	(3.4)	(0.1)		
*Farm Equip (Sperry)	4.8	9.9	2.8		
*Indust. Prod. (Textron)	7.2	2.6	0.1		
*Consumer Prod. (Textron)	7.4	7.2	6.9		
*Const./Farm Equip (Tenneco)	(6.1)	(4.2)	(1.1)	1.2	0.8
Nat'l Resources and other (Tenneco)	9.5	6.9	6.1	6.5	4.5
Composite ROS for all above commercial segments, combined	8.0				
Composite ROS for selected commercial segments (similar to USG Business products) denoted above by asterisk	7.7				

The ROS for Northrop's Aircraft Segment reflects the figures published for operating profit in Northrop's Annual Financial Report. The operating profit figure shown by Northrop is the year's operating profit of the Aircraft Segment less the amount spent that year on the F-20, which to this point, at least, is not a USG program. The footnote shows ROS based on operating profit before subtraction of F-20 expenses.

The ROS figure shown for General Dynamics Land Systems (Tanks) is low relative to ROS for other segments/corporations not because making tanks is inherently not as profitable as other defense items but because GD is still amortizing (as firms often do in such cases) part of the purchase price of the tank line (purchased from Chrysler Corp in 1982), against current operating profits. In 1984, $36.6M of the approximately $300M purchase price paid in 1982, was amortized against 1984 operating earnings on the tank business. Without that subtraction the operating profit as a percentage of sales on 1984 operations per se would have been 7.2% for GD Land Systems, in line with the ROS figures for other segments/corporations.

For 1984, the range of ROS's is a relatively narrow 6-15% (compared to the range of ROA's to be shown in the next table) and most of the 1984 figures are relatively consistent with prior-year figures.

The ROS for GD shipbuilding for 1984 is back in line with other government shipbuilders; GD's operating earnings figures for prior years were damped by operating loss carry-forwards from prior year submarine losses. Lockheed Shipbuilding shows a major decrease in ROS for 1984; operating profits were 1/2 their 1983 level (a peak year) even though sales increased 4%. Avondale's ROS is down from 1983, but still well above prior-year ROS figures. Newport News Shipbuilding (a segment of Tenneco) shows a sustained, steady increase in ROS; 1984 sales are double the 1980 figure and 1984 operating profits are 3.8 times 1980 operating profits. TI's Government Electronics Segment showed a decrease in ROS in 1984; sales increased 15.6% but profits decreased about 10% from 1983 levels. FMC's ordnance/land system segment, Defense Systems, showed an increase in ROS for 1984; while sales increased 7%, operating profit increased 46% from 1983 levels.

The above mention of individual segments/corporations are by no means meant to provide in-depth insight into specific Defense Contractors; that sort of thing is more properly the subject of other reports. Again, the additional detailed data for each of the 22 corporations is provided in the later part of this report.

The bottom part of Table II shows composite ROS figures for the USG business for the segments where a clean break-out could be made and a separate composite figure for segments where the break-out was not as clear-cut (those denoted by footnote 2) where the figure reflects results on some commercial business as well as USG business. The second figure is the composite ROS achieved by these same 22 corporations in a wide variety of purely commercial markets. The Commercial ROS represents results from about $80B in sales in 1984, about the same level of sales dollars as are represented in the USG and mixed segments in the table. The last figure shows the composite ROS for a selection of commercial segments where products were judged similar to products in the USG segments. The second page of Table II shows the commercial segments/corporation and the individual ROS's for 1984 back to 1980.

The ROS on USG business measures about 15-20% higher (9.2% vice 8.0-7.7%) than ROS in commercial business in 1984. Later in this report composite ROS's will be shown for 1977 through 1984. That longer period analysis shows ROS's to be close but changing from commercial higher initially to USG measurably higher since 1981. Note here in Table II that: (1) most commercial business numbers are a little higher in 1984 than in 1983-1980 (e.g., Tenneco's and Rockwell's Automotive Parts Segments); (2) very small and negative numbers are much more common in commercial business than in USG business as are some very large ROS figures.

Table III is similar in structure to Table II except that Table III shows the ROA, Operating Profit divided by Identifiable Assets, for the 22 Corporations in USG segments and in the Commercial Business segments listed . Several things are immediately apparent from Table III.

First, the ROA's for USG business are much larger, generally, than the ROA's for the commercial business shown segments on the second page of the table. Note again the several segments/ corporations where the numbers reflect ROA's for a mix of USG and commercial business. For those segments/corporations (GE, United Technologies, Textron, Rockwell Electronics and Sperry), in particular, the ROA's appear lower than the other segments which are all-USG business but generally higher than commercial segment

TABLE III

COMPARATIVE RETURN ON ASSETS (ROA[1]) Government Sector

U.S. GOVERNMENT	1984	1983	1982	1981	1980
Aerospace(A/C,Eng,Miss,etc)					
Boeing	29.3	31.7	35.5	28.3	16.0
General Dynamics	48.9	54.2	51.0	40.9	31.8
General Electric[2]	15.4	16.0	15.8	16.5	16.2
Grumman	19.7	20.9	23.5	23.8	20.7
Honeywell	14.5	15.5	13.0	16.1	16.9
Lockheed	22.2	19.9	22.0	28.8	25.0
Martin-Marietta	34.9	54.3	57.6		
McDonnell Douglas	26.9	21.3	20.4	27.1	10.8
Northrop[3]	19.6	15.2	8.2	3.4	16.2
Rockwell	29.5	31.8	25.8	30.4	19.3
Textron[2]	8.2	11.3	11.5		
United Technology[2]	13.3	17.7	17.7	12.9	11.3
Shipbuilding					
General Dynamics	44.4	20.6	(7.0)	(2.6)	4.5
Litton/Ingalls	76.3	68.7	50.0	51.5	66.2
Lockheed	16.9	47.1	30.8	71.4	41.2
NASSCO	52.3	40.2	33.9	19.5	20.9
Avondale	10.2	13.0	4.1	3.5	(3.3)
Newport News	30.0	23.9	21.1	14.9	10.4
Todd[4]	9.1	9.3	15.0	22.0	15/1
Electronics					
General Electric[2]	17.8	12.3	9.5	10.8	13.4
Litton[2]	18.0	21.3	22.8	26.9	27.1
Northrop	22.2	29.2	24.1	28.6	25.0
Raytheon	25.4	18.6	16.5		
RCA	23.8	33.7	30.1	32.8	28.0
Rockwell[2]	15.5	15.6	15.2	9.8	14.1
Sperry[2]	17.8	21.8	20.7		
Texas Instruments	23.1	38.8	51.1	44.4	26.6
Ordnance/Land Systems					
FMC	53.7	46.1	25.8	18.9	35.6
General Dynamics	8.0	8.0	4.4		
Composite ROA for all USG-only segments above	26.7				
Composite ROA for mixed USG/commercial segments above (denoted by [2])	15.1				
Composite ROA for $80B of Commercial Business (see next page)	10.7				
Composite ROA for selected commercial segments (see next page)	11.3				

[1] Operating profits divided by identifiable assets of the segment(s).

[2] At these corporations, the segment(s) that include the USG business also include commercial business and it is not possible, given the data sources, to separate profits from USG business from profits from commercial business within the segment. The same is true of identifiable assets. Therefore, the ROS/ROA figures shown here are the figures for the entire segment which includes USG business rather than for USG business *per se.*

[3] The figures shown above for Northrop Aerospace are based on profit figures that are calculated by Northrop by subtracting F-20 costs from achieved profits on programs that have/are achieving sales and profits. F-20 expenses total some $774M through 1984. ROA's computed based on operating profits on aircraft programs whose sales generated those operating profits, without subtracting F-20 expenses, are: 1984 - 26.9; 1983 - 25.6; 1982 - 18.1; 1981 - 11.3; 1980 - 10.3.

[4] See footnote #15 on Table I.

TABLE III (continued)

COMMERCIAL SECTOR ROA (COVERS APP. $80B SALES IN 1984)

Industry (Company)	1984	1983	1982	1981	1980
Food Products (Ogden)	5.9	4.6	3.0	9.3	11.7
Oil, gas & chem (Tenneco)	10.3	11.2	14.4	15.9	16.5
Indust. chem. (FMC)	20.2	19.0	17.2	17.2	15.0
Perform. chem. (FMC)	16.4	8.5	4.4	18.4	(0.7)
Energy (Raytheon)	4.6	4.8	15.8	19.4	17.9
Constr. & Engr. (M&K)	11.5	10.2	13.2	16.8	17.6
Constr. (Northrop)	Discon.	(255.6)	(5.0)	15.0	65.2
*Bldg. Sys. (U.T.)	10.3	14.6	14.4	17.5	16.7
*Indust. Prod. (U.T)	11.6	7.1	1.7	1.8	11.0
*Gen. Indust. (Rockwell)	18.8	14.5	16.9	27.9	18.1
*Spl. Mach. (FMC)	10.9	(3.8)	(7.5)	(1.0)	(3.1)
*Metallur. Mater. (T.I.)	15.6	24.7	14.1	20.7	29.4
*Power Sys (G.E.)	21.4	21.1	18.7	12.0	9.9
*Elect. & Electron. Prod. (Litton)	20.2	16.0	16.4	20.2	19.0
*Control Prod (Honeywell)	21.0	5.0	9.9	12.9	18.1
*Control Sys. (Honeywell)	12.7	13.9	20.1	19.4	18.4
*Electron. Comp. (T.I.)	35.0	21.9	3.7	2.7	23.6
*Info Sys. (Honeywell)	13.7	9.9	5.8	11.5	13.7
Business Sys (Litton)	Discon.	(3.6)	--	8.6	8.9
*Digital Prod. (T.I.)	(0.2)	(133.5)	3.1	4.5	11.0
*Commer. & Consum. Prod. (RCA)	6.9	6.5	7.7	4.8	12.9
*Consum. Prod. (GE)	23.2	20.1	16.3	18.8	23.2
*Appliances (Raytheon)	13.4	13.6	6.1	7.0	5.7
*Trans. Acft. (Boeing)	0.0	2.1	0.3	6.6	20.6
*Trans. Acft (MDC)	2.0	(1.9)	(2.1)	(3.8)	(6.0)
*Automotive (Rockwell)	21.4	5.0	5.4	2.0	10.2
Transportation (RCA)	2.5	3.5	3.0	1.6	6.1
Communications (RCA)	10.7	9.7	18.3	12.0	15.7
Broadcasting (RCA)	20.5	16.5	13.1	5.8	9.4
Services (FMC)	(8.3)	(2.5)	20.2	24.3	20.6
Services (GE)	7.5	15.6	16.2	18.8	18.7
Services (Litton)	12.2	14.9	30.0	29.3	31.4
Services (Ogden)	13.6	12.7	13.4	13.9	10.8
Services (T.I.)	(17.9)	11.1	31.9	36.6	27.6
*Automotive (Tenneco)	26.4	20.9	14.8	10.6	5.8
*Basic Prod. (Martin Marietta)	19.5	18.8	3.3		
Information Sys. (MDC)	(4.0)	(4.0)	(0.1)		
*Farm Equip. (Sperry)	6.9	15.3	4.1		
*Indust. Prod. (Textron)	14.2	4.6	1.1		
*Consumer Prod. (Textron)	14.3	14.9	14.0		
*Const./Farm Equip. (Tenneco)	(6.7)	(4.6)	(1.4)	1.6	1.1
Nat'l Resources and other (Tenneco)	6.7	4.8	4.0	4.0	2.9

Composite ROA for all above commercial segments, combined	10.7
Composite ROA for selected commercial segments (similar to USG Business products) denoted above by asterisk	11.3

ROA's. As mentioned above, GD's Land System number is affected by the way the Tank Line purchase is being treated; ROA for actual operation in 1984 was 14.8%. One major reason for the decrease in USG ROA at TI from 38.8% in 1983 to 23.1% in 1984 was an increase in identifiable assets associated with that segment from $454M in 1983 to $688M in 1984. The apparent causes probably include expansion of 2 facilities, opening of a new plant and conversion of a former commercial plant to use on USG business. The complete explanation for the $234M (51.5%) increase in assets is not evident from the available data.

Second, there is considerable variance among the individual segments/corporations.

Third, there are far more very small or negative numbers in commercial business than in USG business.

Again, detailed data in the operating profits and identifiable assets for each of the segments of all the 22 corporations for 1984 and prior years are provided at the back of this report.

The numbers at the bottom of Table III show a 1984 composite ROA for the USG segments of 26.7% compared to a composite ROA of 10.7% for commercial business at these same corporations and an ROA of 11.3% for selected commercial segments, in 1984.

An Historial Perspective on Relative Profitability

Figure 1 shows, graphically, the annual ROS's and ROA's for USG, for commercial business [6], and for selected commercial

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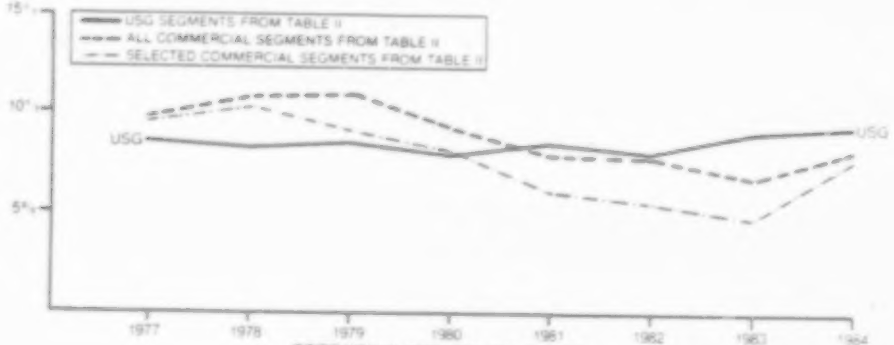
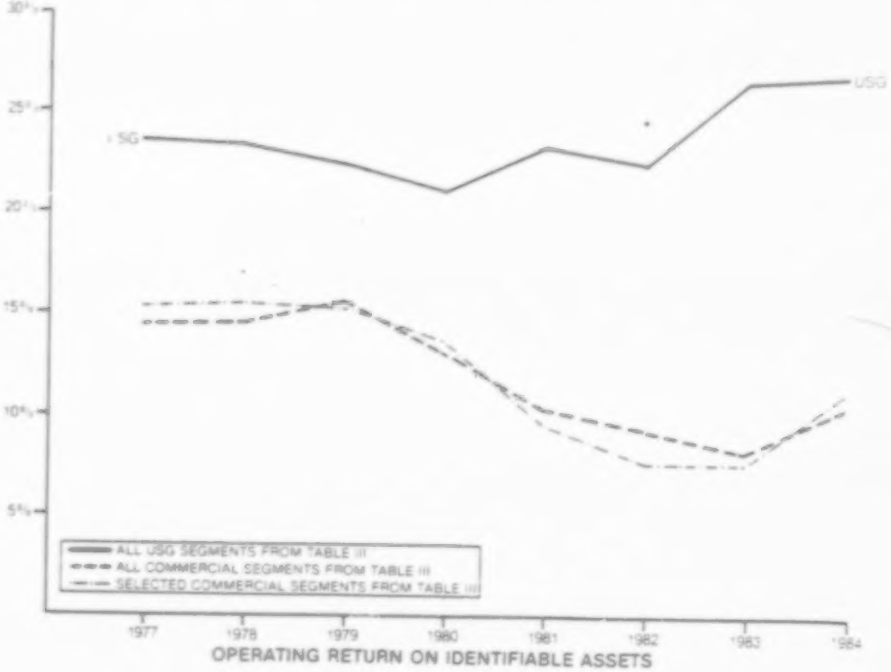
[6] As in (Tables II and III), above only data from individual segments of the 22 corporations analyzed that were clearly within either USG or commercial markets was used in generating these figures. About 90% of the 100 or so segments within the 22 corporations were assigned as representing either USG or commercial business. About $130B in sales for 1984 are covered.

FIGURE 1
COMPARATIVE PROFITABILITY OF USG AND COMMERCIAL



OPERATING RETURN ON SALES



OPERATING RETURN ON IDENTIFIABLE ASSETS

segments (that had products similar to products in USG business), for 1977 through 1984. Table IV shows the numbers obtained from the analysis and used to generate the graphs.

Consider the ROS graphic, the graph at the top of figure 1. That graph shows ROS on commercial business (all segments or selected segments) was higher than the ROS for USG business until 1980 but by 1981 the lines had crossed and ROS for USG business has remained measurably above the ROS for commercial business through 1984. Note that both the USG and commercial curves changed. The commercial ROS began to decrease in 1979, possibly due to whatever form of economic recession one cares to postulate for all or some of the 4 years between 1980 and 1983, and has just begun to show an increase in 1984. But the USG ROS curve itself increased starting with the operating results for 1983.

The ROA graph on the bottom of Figure 1, shows a similar but different pattern and much more pronounced differences. While ROS's for USG and commercial business were at relatively (compared to ROA's) comparable levels for the whole period, the ROA's were very different throughout the whole period. Composite USG ROA is higher than composite commercial ROA's for the entire period and was over 1.4 times commercial ROA even in the best years for commercial ROA. In 1984, USG ROA was 2.4-2.5 times the commercial ROA.

Again both curves changed: the USG curve increased and the commercial curves decreased. The total observed increase in the USG: commercial ROA ratio is not due merely to a decrease in the commercial ROA's but to the increase in USG ROA's as well. Even

TABLE IV
HISTORICAL PROFITABILITY DATA

	1984	1983	1982	1981	1980	1979	1978	1977
ROS								
USG	9.2	8.9	7.8	8.2	7.8	8.3	8.1 1/	8.5
ALL COMMERCIAL	8.0	6.6	7.8	7.9	9.2	10.8	10.7	9.9
SELECTED COMMERCIAL 2/	7.7	4.9	5.6	6.0	8.0	9.0	10.1	9.6
RATIO USG TO ALL COMMERCIAL	1.15	1.35	1.00	1.04	0.85	0.77	0.75	0.86
RATIO USG TO SELECTED COMMERCIAL	1.19	1.82	1.39	1.37	0.98	0.92	0.80	0.88
ROA								
USG	26.7	26.4	22.5	23.3	21.1	22.5	23.4 1/	23.8
ALL COMMERCIAL	10.7	8.2	9.3	10.4	13.0	15.9	14.8	14.7
SELECTED COMMERCIAL 2/	11.3	7.9	7.9	9.8	13.8	15.5	15.8	15.6
RATIO USG TO ALL COMMERCIAL	2.50	3.22	2.41	2.24	1.62	1.42	1.58	1.62
RATIO USG TO SELECTED COMMERCIAL	2.36	3.34	2.85	2.38	1.53	1.45	1.48	1.53

1/ These numbers exclude General Dynamics data for 1978. In 1978 GD showed a major operating loss ($338M) in USG Shipbuilding. The ROS with GD included is 6.1 and the ROA 17.6 for 1978. The GD's loss was larger than any of the other corporations' profits on USG business that year. GD's 1978 loss was twice GD's profits in 1977.

2/ Selected commercial includes only those segments noted with an asterisk on Table II and III. These segments were selected from the set of all commercial segments as representative of manufacturing activity most similar to USG business products.

if commercial ROA's had stayed at about 16% through 1984, USG ROA would have been 1.7 times that supposed commercial ROA in 1984.

The commercial ROA began to decrease in 1979 and, while still below 1977-1979 levels, shows an increase in 1984. In contrast, the USG ROA curve shows a major increase from previous levels after 1982. Results for 1983 and for 1984, show increases in composite USG ROA from prior levels.

It is not appropriate given the specific scope and nature of this report to attempt to determine specific reasons for the relative positions and shapes of the curves or to determine how the curves should look. Answers to such questions are important issues for USG procurement management and should be pursued.

The changes in the USG ROA curve in 1983 and 1984 and recent and prospective changes in Defense profit policy and USG financing rates and levels, especially by the Navy, and the increased emphasis on competition, make the corporate financial results for 1985 and subsequent years of more than usual interest. This analysis is scheduled for update as the corporate financial data becomes available.

Chairman **Hubbard**. Congressman George Wortley of New York State.

Mr. **Wortley**. Thank you, Mr. Chairman.

Ms. Spector, for the record, again, could you tell us what is the percentage of contracts, defense contracts, that are negotiated, and what are competitive, the percentage and numbers of contracts, and also the dollars?

We used to talk about approximately 94 percent of all the Defense Department contracts being negotiated. What is that percentage down to today?

Ms. **Spector**. Sir, I will submit precisely the answer for the record, but negotiated and competitive are not opposites.

The Competition in Contracting Act says that sealed bidding and negotiated competition are equivalent. We negotiate many of our requirements; you can't put out an invitation for bid on a major weapons system.

There has to be some negotiation of requirements, negotiation of dollars, getting the best price and then going for best and final offers on many of our systems.

Mr. **Wortley**. I understand that.

Ms. **Spector**. We negotiate many things that are competitive. Our competition rate in dollars is about 47 percent for 1985. That is what we compete.

Mr. **Wortley**. Seventy-five——

Ms. **Spector**. Forty-seven percent we have received through competition in 1985.

Mr. **Wortley**. That is in dollars?

Ms. **Spector**. Yes. It is in excess of 65 percent in actions, number of actions.

[In response to the request of Congressman Wortley, the following information was submitted for the record by Ms. Spector:]

COMPETITION STATISTICS

Preliminary figures indicate our rate of contract competition has inceased about five percentage points to 48 percent (in dollar terms) in FY 1985 over last year and more than seven points since FY 1982. Final figures may be higher. We awarded $67.4 billion competitively, $14 billion more than FY 1984, and $25 billion more than FY 1982. We awarded 71.6 percent of the number of contract actions competitively versus 63.1 percent in FY 1984 and 52.6 percent in FY 1982.

Mr. **Wortley**. How far behind do you usually run in terms of your audits, about 6 months after a contractor has completed, you will get into an audit, or is it a longer period than that?

Ms. **Spector**. We don't audit every contract after it is complete.

Mr. **Wortley**. What contracts do you audit?

Ms. **Spector**. Incentive-type contracts would be audited after they are complete, because we do a redetermination of the profit to adjust the incentive formula.

Firm, fixed-price contracts, competitive contracts are normally not audited after completion. We don't audit every contract.

Mr. **Kendig**. I would like to add that the procedure used in the auditing especially at the large contractor locations, is an ongoing continuous audit that is peformed by the Defense Contract Audit Agency. By this procedure, the auditors are able to audit it across the board through the contractor system for costs that are associated with all the contracts that the contractor is performing at the time.

So there is an up-to-date, real-time-type auditing during the course of the year which will apply to the ongoing contracts that are performed during those years.

Now, you then have at the completion of contracts, you have to accumulate all this data. The contracts will have run for 3 or 4 years, so you have to put all this together. And then when the contractor comes in with his final proposal on a settlement of a flexibly priced contract, it may take another 4, 5, 6 months before you wrap the whole thing up, but it is a constant audit being performed.

Mr. WORTLEY. You wrap it up within 4 to 6 months after the contract expires?

Mr. KENDIG. At the end of a contract, what the contractor comes in with is a final proposal on incentive-type contracts, a proposal that says, OK, we negotiated a target and we negotiated a ceiling when we started out. Here are my actuals in connection with all of what happened over the past 4 years. Based on the formula, this then is the final cost that I want to have for the contract.

The Defense Contract Audit Agency then has to examine that. If there are any questionable costs that are a part of what the contractor submitted, they must submit a report on that.

Then there is a final negotiation using all the questions raised by the auditor and the target formulas that were negotiated in the beginning to come down to the final price.

So, on those big contracts, which are most of the ones that have the real big dollars, we do have knowledge of, at least from the viewpoint of marginal cost, how much money the contractor is making on those contracts.

Mr. WORTLEY. Mr. Chairman, I would like to follow up and ask, does this same type of audit follow on spare parts contracts or just on the incentive contracts, the big-ticket items?

Mr. KENDIG. Many of the problems involved in spares are associated with the major procurement contracts. We buy spares as a separate item and we also buy spares, initial-type spares, that have to be delivered with the hardware itself, so some of the cases that you heard about, some of the stories that have come out——

Mr. WORTLEY. The horror stories.

Mr. KENDIG. Right, they have been associated with those replenishment and spare parts that are delivered as a part of the weapon system contract itself, so to the extent that the spares are under those contracts, they are part of that settlement that I am talking about.

To the extent that they are a part of firm, fixed-price contracts that may be coming from the—requirements type, you know, the replacement spares for those things that are already out in the field, in many cases, no, these are firm, fixed-price contracts and we are not having some kind of a determination at the end of the final price.

Mr. WORTLEY. Those horror stories that we hear about on spare parts, when you determine that there is an overcharge, is that usually determined by your operation or is it the Congressional Budget

Office or the General Accounting Office—who usually comes up with those?

Mr. KENDIG. Well, the Defense Contract Audit Agency has been one of the prime identifiers of this. The inspector general over the past few years has contributed greatly to these revelations.

I think that basically within the Department of Defense, they would have accounted for substantially all of the so-called horror stories that have gotten into the paper.

Mr. WORTLEY. Thank you very much.

Thank you, Mr. Chairman.

Chairman HUBBARD. Thank you, Congressman Wortley.

We now call on Congressman Doug Barnard.

Mr. BARNARD. Thank you, Mr. Chairman.

Ms. Spector, Mr. Math in his testimony indicated that the General Accounting Office was concerned about the validity of the study—do you pronounce that "DFAIR"?

Ms. SPECTOR. Yes.

Mr. BARNARD. Sounds like how we would pronounce it in Georgia. He indicates that the validity of the study is maybe somewhat in question. Do you share the same concern? Does your area share the same concern that he does?

Ms. SPECTOR. No, sir. The data was requested on a voluntary basis from the top 100 contractors and some smaller. We asked for comparable data on their commercial segments.

A lot of the Government data we could have gotten ourselves and is auditable. It is the stuff on the commercial comparison data that wasn't readily available to us.

Each contractor had the data certified by its own accounting firm, signed as being correct, so it is not as though it is just tossed in. It was certified and it went through Touche Ross, who worked for us.

The reason for confidentiality is, we were asking for a substantial amount of data that we are not otherwise entitled to and wouldn't get on a routine basis. I don't think that the study is wrong or is incorrect or is invalid for that reason.

I have a fair degree of confidence in the data, and don't share GAO's concern with it.

Mr. BARNARD. He also said in the November 1984 letter they recommended—on page 5 of the testimony—periodic profit studies based on regular reported data on defense contract profitability to be established.

What is your position on that recommendation?

Ms. SPECTOR. I wouldn't mind doing it. I have no objection to doing that.

Mr. BARNARD. He indicated that the fundamental areas to be addressed would include the actual profits earned and level of investments and so forth.

Do you see any unusual problem that would be for the Department of Defense?

Ms. SPECTOR. I think were we to gather data on all contractors doing over $5 million of business with us, it might be an unnecessary burden on a lot of very small companies.

Were we to do something like that, we might want to limit it to a representative sample of contractors.

We discovered at the Renegotiation Board, it was costing about $100 million a year just to gather the data. Were we to limit to maybe 100 contractors, the cost of the data collection would not be as great and maybe we could do something like that.

Mr. **Barnard**. You are saying it could be that the cost effectiveness of that recommendation could be just as costly as the Renegotiation Board's?

Ms. **Spector**. Depending on the way we gather the data and from whom.

Mr. **Barnard**. You are considering that as a possibility?

Ms. **Spector**. We certainly would consider it.

Mr. **Barnard**. I understand that Derek Vander Schaaf, who is the Deputy Inspector General, testified before the Government Operations Committee that he preferred strengthening the Truth in Negotiations Act to any proposals for renegotiation.

What is your opinion of that statement?

Ms. **Spector**. I would probably share his view. In fact, on renegotiation, I guess I would not advocate renegotiation at all.

The gathering of the data and adjusting our policies based on it is what I would not object to. Renegotiation is something I would not advocate.

Mr. **Barnard**. I am sure this has been covered by other Members, but I would like to reiterate this.

We have been talking again about these exorbitant prices that we have paid for various articles. I didn't know about braziers, Mr. Gonzalez. But coffeepots and hampers, would the revival of the Renegotiation Board remedy this problem?

Ms. **Spector**. I don't think so, sir. As I did mention, a lot of the horror stories are where we are buying low-dollar-value items, comparatively low, in small quantities from prime contractors.

Those spares, because we are buying 12 of them, are in many cases overpriced but would 12 hammers or any of these things show up in the profit of one of our largest corporations from whom we are buying them? The answer is, probably not.

It would be subsumed so that we wouldn't be recouping money from large primes for spares, by and large. That is not where they are making their big money, which is why most of them responded they would be willing to give us voluntary refunds in that area.

It is not a big income maker for them.

Mr. **Barnard**. I have just a few minutes left, but in the time I have remaining, would you tell us something about the Truth in Negotiations Act and how you see that working to avoid excess profits.

Ms. **Spector**. In negotiated procurements, which are the substantial volume of our procurements, contractors have to give us current accurate and complete cost and pricing data showing how they develop their price. It can consist of actuals; it can consist of virtually anything we ask for that contributes to development of the price.

With the proposal, we get a substantial amount and as the negotiation progresses, we get more. We can then get a fairly accurate assessment of costs.

Where excessive profits are made is not in negotiated profit, but it is where we don't accurately assess costs. Truth in Negotiation prevents padding costs and that is the area we should be looking at. It enables us to make an accurate assessment of costs so that we don't have excess profits.

Mr. **Barnard**. In your operations, you have an ongoing operations to implement the Truth in Negotiations Act?

Ms. **Spector**. Every single negotiation.

Mr. **Barnard**. So this is in place, it is operative, and so it is an ongoing process that you have today?

Ms. **Spector**. Yes, sir.

Mr. **Barnard**. Would the Reneogotiation Board be a duplication of that?

Ms. **Spector**. I wouldn't say that it would be a duplication.

Mr. **Barnard**. Because this is before the fact rather than after the fact?

Ms. **Spector**. Yes, sir. It is a different perspective.

It is going back and getting if he happens to have underrun. I assume that is the situation. It would be different.

It wouldn't exactly be a duplication, in my opinion.

Mr. **Barnard**. Thank you.

Chairman **Hubbard**. Thank you, Congressman Barnard.

Congressman Steve Bartlett of Texas.

Mr. **Bartlett**. I am not going to spend much time on the proposal of the Renegotiation Board since I concur with the witnesses. I think it is a discredited idea and probably would add to costs in the process.

Let me ask several questions, though, of both witnesses on the whole procurement process.

First, on the process that I suppose I would describe as overengineering or overspecifications, I wonder what efforts that you see the Defense Department either is taking or should take in the future to prevent the overdesign—let me be specific.

We have heard, I guess, the example of the $7,000 coffeepot, which was sort of laughed at, and it should have been. The only difficulty is when you looked at the design for the coffee, it is a wonder that anyone could make a coffeepot to those specifications for $7,000, or the $100 washer, because it was made from scratch as opposed to in large quantity or other items.

Are there efforts under way or should there be efforts underway to increase the number of stock items that we buy where literally we could purchase from a hardware dealer stock items in stock quantities, particularly for noncritical components?

Secretary Spector.

Ms. **Spector**. There absolutely are efforts underway. We have streamlining efforts well underway, initiatives in each of the services underway to prevent overdesign. We have also emphasized to the contractors to tell us when we are overdesigning things.

We have tried to go out with performance specs at the beginning of the design stage of a program. We are emphasizing using off-the-shelf items.

We have tremendous initiatives underway, but of course you won't see the results of those until after a 3- to 5- to 7-year full-scale development, and then it goes into production and we buy spares. So a lot of the things we are buying spares for now you will continue to hear stories of possible overdesign, stuff designed 20 years ago before the initiatives.

The case of the toilet seat and ashtray is an old airplane. We are trying terribly hard not to do that anymore, and I think the services have taken those initiatives very, very seriously, as have the contractors.

Mr. BARTLETT. Mr. Math, do you see evidence of changes in terms of the design, or has GAO looked at that at all?

Mr. MATH. We haven't looked at the streamlining program that Eleanor mentioned. I think it is a very important area in terms of overspecifications whether it be on those items you mentioned or on the major end items, getting down to the very specific "how-to's."

It should do all these specific things. It would be better to establish a requirement and then let the community determine how best to satisfy that requirement without telling them that that should do this, this, this and that is what we are talking about, overspecification.

Mr. BARTLETT. Secretary Spector, you commented that at the beginning of the design process there is streamlining or an attempt to put out for bid what the purpose of the system or the component is.

I take it from that response that we still then put the rather detailed designs of every item into the designs and onto a set of blueprints and specify the material.

Is there any attempt to try to separate between the critical and noncritical components, even in the final purchase, so that you can buy a No. 15 washer as a No. 15 washer as opposed to a——

Ms. SPECTOR. We have several spare initiatives to look to see if we are paying more than the intrinsic value on any spare.

We are looking at every spare that comes through. We have initiatives at Defense Logistics Agency and in all three services to screen the spares.

We are getting competition where we haven't received it before. In some cases, we may be looking at redesign of old parts to try to avoid this kind of problem.

So, yes, we are taking several initiatives in that area.

Mr. BARTLETT. What changes have been made in terms of allowing—of renegotiating contracts, if that is necessary, or assuring that we negotiate that 52 percent of contracts that are not competitive bids, that are sole-source, so that the spares replacement of the Allen wrenches can be in and of themselves competitively bid when they are purchased?

As I understand it, one of the problems was that the prime contractor, as you said, who got the prime contract also had the contract to, on a formula basis, supply the spares.

How many of those contracts do we still have like that, or have we converted a significant number into allowing the Defense Department to bid out the spares on competitive bases?

Ms. SPECTOR. We are screening a lot of the spares you referred to. We are screening 142,000 parts this coming year for breakout possibilities, breaking them out from the prime and going direct to the source so that we don't have those kinds of problems.

We are incentivizing employees with money or with performance objectives to look for these kinds of things, and we are getting competition on items we weren't getting competition on before.

We are screening every list of spares. We have projects, BOSS [Buy Our Spares Smart] and Price Fighter, and programs that clearly incentivize our people to do things intelligently and to use judgment.

Mr. **Bartlett**. Do you have a quantifiable answer as to what percentage of the sole-source contracts of primes still supply their own spares?

Ms. **Spector**. I would say they all do on certain spares. There are certain items we must go to the prime for.

We are breaking out substantial portions and we are getting competition on substantial portions.

There are certain spares that we must go to the prime for. It is not for off-the-shelf-type items.

Mr. **Bartlett**. A layman, I suppose, would suggest that the way to find out which spares can be competitively bid and which cannot would be to simply competitively bid spares, and if no one bids except the prime, that gives you at least a pretty good indication that the prime is the only available source.

Ms. **Spector**. The law requires us to do that now and we are doing it.

We have to synopsize all the procurements and consider every proposal that comes in. So indeed we are doing exactly what you said.

Mr. **Bartlett**. My time has expired.

If either of you have an answer to an open-ended question—what is the impact of congressional mandates on procurement, and which would be your priority for reduction or elimination of congressional mandates to reduce cost? Would it be elimination of Davis-Bacon or elimination of micromanagement? What could Congress do?

I know the answer is not reestablish a Renegotiation Board.

What should Congress do to increase procurement efficiency?

Ms. **Spector**. I am not sure we need much of what is in the whole 1986 Authorization Act in the area of procurement. There is an awful lot in there. Our negotiators are having a difficult time keeping with all the new rules.

The volume is hurting us, delaying procurement, forcing us into unpriced actions to try to comply with all the rules.

I would like to see us hold off and absorb what we have, put our reforms and yours into place.

One piece of legislation last year caused us to revise one-third of all our regulations.

When you magnify this by the amount of legislation we have had, it is having a tremendous impact on that learning curve of performance. Whether it is good or bad, I would like to see you hold off on much more legislation of any kind.

Mr. **Bartlett**. Mr. Math.

Mr. **Math**. Let me suggest that regarding additional legislation, other than the proposal we have in our statement on the mandatory reporting system and the periodic studies, and we have not as an organization, taken a look at legislation in terms of micromanagement. We are doing work now on spare parts. A lot of the programs that were legislated are good programs, things that DOD should have been doing in the first place.

So I am not prepared to comment on all the legislation. There are the pieces that are good and there are the pieces that are bad. I don't have any additional legislation, other than that proposed in our statement, that I would propose nor would I recommend elimination of existing legislation.

Chairman **Hubbard**. Thank you, Congressman Bartlett.

We now call on Congresswoman Marcy Kaptur of Ohio.

Ms. **Kaptur**. Thank you, Mr. Chairman.

I wanted to ask both the witnesses to rate on a scale of 1 to 10, 1 being the very best and 10 being the very worst, the way in which our Government is currently organized to avoid excess profits, going to recipients of defense contracts. Putting all these different pieces of legislation that you have summarized together from your own gut level impression would you tell the lay person that we are at 1, 5, or 10?

How well organized are we to avoid an excess profits situation and to encourage competition in the defense industry? How far along the path do you think we are? What was your cumulative assessment.

Ms. **Spector**. Is 1 the best?

Ms. **Kaptur**. Yes, 1 is the best.

Ms. **Spector**. I would say we are somewhere around 2, right around the 2 area of excess profits. As far as competition I have to rate our emphasis now a 1. We are really looking to compete absolutely everything that is possible to get competition on. I would have to say we are at a 1 in advocating and encouraging. We are obviously not perfect in getting it in every case we would like to.

Ms. **Kaptur**. Mr. Math, can I ask you that question? All I am asking for is No. 1 to 10.

Mr. **Math**. I would say about 6, I guess, and the reason I say that——

Ms. **Kaptur**. I should show you the questionnaires that come in from my constituents.

Mr. **Math**. The reason I say that is because without the mandatory reporting system we propose, we don't have a good handle on what the profits, the coming out profits, are. I think that what we need is to be able to determine is how well we are doing with all these processes and all these systems in determining what the contractors profits are.

Ms. **Kaptur**. I have a major defense contractor that employs approximately 850 people in my district, and that includes the management level staff. They do things like build a Harpoon engine, as well as the J–69 for the Air Force training planes.

Outside this plant there is a trailer, several trailers where all the Government people sit who monitor what they do inside this plant. Now, there are at least three dozen Government people at all times on site. Again, for a lay person could you explain to me who are they, and for whom do they work? The reason I ask is because one of the things I wondered about is streamlining all of these people who are supposed to monitor everything this particular corporation is doing.

Could you explain to me based on what you have said how are those people in these trailers organized? To whom do they report?

Mr. **Math**. I would presume they would be price analysts, I doubt there is an onsite DCAA organization there, but I would presume they would be Government representatives who look at the pricing of contracts to determine whether, when proposal is made and a contract comes to that company the costs that were incurred in the previous contract were used to determine if the costs that are being proposed are fair and reasonable.

Ms. **Kaptur**. Among these acts that were summarized for us, take the Truth in Negotiations Act. Does that produce most of the bodies in those trailers?

Mr. **Math**. The Truth in Negotiation Act, does not provide for those bodies to be there; the Truth in Negotiation Act is to assure that the contractor and the Government are negotiating with the most current, fair and accurate data available.

Now in order to determine if the contractor data is accurate before you enter a fixed price contract, you need the Government representatives to take a look at records behind those prices and see if they are fair and reasonable before you sit down and negotiate.

Ms. **Kaptur**. Are you telling me those are not the people that are there right now? Those are not the people onsite?

Mr. **Math**. Those people that are attempting to determine whether the proposal that has been submitted by that company is fair and reasonable.

Ms. **Kaptur**. Under what authority are they there? This is an area I don't know anything about. You could really do a good job in teaching me this morning.

From which act do they flow?

Mr. **Math**. Good question. They flow from the procurement regulations that require Government organizations to evaluate the pricing of contracts.

Ms. **Kaptur**. Is that in your testimony, Eleanor?

Ms. **Spector**. I would like to possibly answer that. Those people would be the contract administration function people. They would be inspectors, quality inspectors, they would provide advisory reports on the technical and cost aspects of proposals that that company is submitting.

Ms. **Kaptur**. Where do they come from in the public laws you have described here?

Ms. **Spector**. I don't know which public law they would come from.

Ms. **Kaptur**. This is one of the things confusing me. You made the criticism that the bills we are passing up here make your life more difficult.

Ms. **Spector**. Yes.

Ms. **Kaptur**. I have never found anybody who is really able to explain to me how all these people fit together or under what authority they are onsite all of a sudden.

Ms. **Spector**. They are not there all of a sudden. They are there the whole time, should have been.

Ms. **Kaptur**. They are there, yes.

Ms. Spector. Basically the contracting officer's onsite assistance people are there. They are the quality inspectors, there are pricing advisory people.

Ms. Kaptur. But they are all DOD people?

Ms. Spector. I think so, yes.

Mr. Math. Yes.

Ms. Spector. I guess it is a DOD contractor and they would all be DOD people. Defense Contract Audit Agency people possibly, they might be contract—DCAS people, Defense Contract Administration Services people, I would assume all DOD if it is an all DOD plant.

Ms. Kaptur. Does that seem like a lot of people?

Ms. Spector. How many, I am sorry?

Ms. Kaptur. Fifty for a plant that employs 800 to 850.

Ms. Spector. Are they only doing that one contract?

Ms. Kaptur. I have no idea what they are doing.

Ms. Spector. I would have to know more details about it. It could be that they are there but they provide services to other contracts.

Ms. Kaptur. I know the time is limited, I come from Toledo, OH, and Teledyne Corp. has its subsidiary there. I would be interested to know who are the Government people onsite, what are they doing and how they relate to one another and under what authority are they there?

Ms. Spector. I can get you an answer on that.

Ms. Kaptur. All right, that would be most helpful.

[In response to the request of Congresswoman Kaptur, the following information was submitted for the record by Ms. Spector:]

Government People on Site—Toledo, OH

The organization is known as the Defense Contract Administration Services Plant Representative Office (DCASPRO), Teledyne, Toledo, Ohio. The Commander of the DCASPRO reports to the Commander of the Defense Contract Administration Services Region (DCASR), Cleveland, Ohio, who, in turn, reports to the Director, Defense Logistics Agency. This organization was established under the general authority of the Inspections Clause (Federal Acquisition Regulation 52.246-2) contained in government contracts as a convenience to both the government and the contractor due to the relatively large volume of defense work and the sensitivity of some manufactured items (such as missile engines).

There are a total 46 people working with the DCASPRO Teledyne as follows:

	People
Commander's office	3
Contract management branch	25
Quality assurance branch	18

Teledyne CAE has a total of 346 contracts now being administered by the DCASPRO with a face value of $317 million. The facility itself is government owned. Teledyne is leasing and operating the plant for the government.

Ms. Kaptur. I know my time is running out, Mr. Chairman, but I wanted to ask Ms. Spector and Mr. Math one other question. The stories we have heard about the coffeepots, the Allen wrenches and so forth, did you consider these to be scandals? I know in one subcommittee meeting I attended we had people from DOD who said in fact they were not scandals, they were merely cost-accounting differences of opinion in which, for some of these companies that are bidding on spare parts, we were including fixed costs in the overhead of that particular company in the calculation of price.

So was it really only a difference in people's views on accounting procedures, or do we really have a problem out there?

Ms. SPECTOR. We had many problems out there. They were not only disagreements, there were several problems in different categories, some were overdesign problems. The spool cap required 20 different tooling operations to make it. There was no need for that. Was it overpriced by the company? No. Anybody who had to do all this would have to spend a fair amount.

That holds true by the way of the coffeemaker which was specified to perform in an environment we didn't necessarily need. We since, by the way, pay considerably less for both of those.

Some of them were an accounting problem where there would be a list of spares and they put the same amount of overhead on each spare, not considering its intrinsic value. So a $10 item would get the same overhead as a $10,000 item. So it would create artificial numbers, the bottom line pricing of the list was probably okay.

We got distorted pricing. That was the explanation for some of them. Some of the things we were buying in a kit where we would get a kit to install something that included parts that were off the shelf but because we were buying them in low quantities through a prime contractor, we would get a contractor's overhead on it.

Perhaps we didn't need some of those items in the kit.

Clearly they were scandals, clearly they got us in an awful lot of——

Ms. KAPTUR. Always in the spare parts area?

Ms. SPECTOR. Yes, that is where it has been. Aircraft spare parts, primarily aircraft spare parts bought in low quantities from prime contractors that have gotten us into trouble, sole source. Those are the ones that have gotten us in trouble, and there is a different explanation on almost every single one.

Rarely was it just—never was it just smacking on a high profit. There were other explanations not all of them sensible, but it was never just they smacking on a high profit.

Ms. KAPTUR. Thank you. My time has expired. Thank you, Mr. Chairman.

Chairman HUBBARD. Thank you, Congresswoman Kaptur.

We now call on Congressman Al McCandless of California.

Mr. MCCANDLESS. Thank you, Mr. Chairman.

I think those people in the trailers out there are from the contracting services, what is the terminology?

Ms. SPECTOR. Defense Contract Administrative Services.

Mr. MCCANDLESS. An area in which I had some problems and who I believe are well intended but if a company is working 6 days a week and the inspectors and overseers of production for quality purposes only work 5 days a week, they cannot ship on time and they cannot get a smooth flow of parts to the basic air-frame manufacturer or whoever it may be.

Some of these things have been corrected in areas, but it still leaves a lot to be desired. I might add that according to certain defense contractors, this adds an additional cost to the end product because of the way that this contract system is implemented, and they are great advocates of returning to the pre-McNamara period when it was handled in an entirely different way.

They claim rightfully or wrongfully that the product is not any better, the quality isn't any better, and that the cost is much higher because they have to go through a number of processes that they would not normally have to.

If that is of any help to you.

What I would like to talk about are a couple of three quick areas. We, here in Congress, are the product of our constituents, and so if we hold a town hall or a forum or something and we have a group of people out there and there is a Q and A and they say well, the hand tools they explain away; the spare parts they explain away; reimbursement agreements, OK, some people are not as careful as others; and so now we are understanding all that. We are not necessarily going to separate but all of a sudden, we get in a little situation here where an aircraft manufacturer is trying to merchandise a certain fighter and maybe he is going to have some success with respect to having that accepted and now all of a sudden, one that is on existing order decides since it is more competitive, we are going to reduce the price of ours and offer our product for less money than we had been selling it to the Defense Department prior to this time.

That is where the difficulty begins, because supposedly these contracts were negotiated out as you have outlined earlier in a manner that provided satisfactory profit but yet gave the Defense Department bank for the buck.

How do you respond to that?

Ms. **Spector**. I believe in the circumstance you refer to, the aircraft proposed at the considerably lower price was also considerably less capable. We were not buying as much in it. It was not just a drop in price for the same airplane.

Mr. **McCandless**. They are trying to sell the F-20, and the F-20 according to those who are knowledgeable has certain pluses and certain minuses. But now all of a sudden, General Dynamics said OK, we will sell you our product for less than we had been selling it to you, we will make you a fleet deal.

Ms. **Spector**. The one they were selling for less was less of an airplane. It is not to say competition won't do wonderful things for us, it clearly will. On the other hand, the airplane they have proposed both to the Navy for their adversary role and to the Air Force is a scoped-down airplane, it is not the same airplane they were charging the higher price for.

Mr. **McCandless**. All right.

Do you have a problem with certain types of contractors who will purposely bid a commodity at a very low price, will get the bid but because they control certain spare parts that are not available on the market, then make it up on the spare parts?

Ms. **Spector**. I have not seen that in practice, no. I have heard it occurs in the commercial world. I have not seen it in defense.

Mr. **McCandless**. You have not experienced this.

Ms. **Spector**. No, sir, I have not.

Mr. **McCandless**. In certain areas in the private sector and other public agencies, gentlemen's agreements are struck between providers. You sell them this this time and I will sell them this next time, and we will both make a few bucks on it rather than cutting one another's toes.

Do you have that come up from time to time?

Ms. Spector. I think they all want to sell us all the time. The problem we have is the reverse, they are all competing and they never settle for the fact we are going to buy it from somebody else or rarely. I don't think we have those arrangements. I have not come across them.

Mr. McCandless. We have what appears to be a career ladder experience situation where the services bring people into this area of procurement, research, development, as a part of their career experience. They are in that for a while, and they move out of that into either field or command positions or something. So, the time that they are in there is a learning process, which is intended to be just that, but it can be costly to the system, also.

Has anyone taken a look at this versus, say, a civil servant career type who would spend his career in that area and become very knowledgeable, rather than this transitional type of thing?

Ms. Spector. Most of our civil servants are spending their careers in procurement when they start in procurement. We are certainly looking at ways to train them better and ways to develop career patterns that are better for the Government. Most of the civil servants who are senior in procurement have spent their whole careers there.

In the military, if you are talking about in the military, I think we are looking at ways of giving people more procurement background in the military.

Mr. McCandless. Mr. Math, have you run across this?

Mr. Math. If I might add, GAO is wrapping up a study now on that, and the draft should be out the end of this week where we took a look at the program managers who are, for the most part, military, and, as you say, may be in operations for an extended period of time and then go to program management with, in some cases, little or no experience in program management.

We looked at the program manager, and we are looking at the contracting officer who is a part of the process of acquiring major weapons systems. We are looking at this, in terms of their roles, responsibilities, tenure, career path and programs, both in the context of what we are considering to be the existing policy and procedures, and also what we consider to be some better policies and procedures.

Mr. McCandless. I have been notified my time has expired.

If I may, Mr. Chairman, just one quick question.

Chairman Hubbard. Certainly.

Mr. McCandless. There is a tremendous amount of interservice rivalry that appears to play an important part in some of the costs of maintaining and operating the Defense Department.

Has this been looked into, as far as we want the black one—we want the black one, and you get the green one?

Ms. Spector. Certainly, it is being looked into. It is not my area. But I think you refer to the problem in developing requirements for systems.

Mr. McCandless. Rather than have a standardization when and where possible, there appears to be a continuous service difference about what could be standardized.

Mr. **Math**. There have been attempts at what are termed joint programs, where you have one program, aircraft, or whatever, to satisfy the needs of more than one service. We looked at that a couple years ago, and we did not find a success story in that area. It is very difficult to get two services to agree that one weapon system will satisfy both their needs.

Mr. **McCandless**. I understand that. I am cocky about more the basic nuts and bolts of the procurement.

Ms. **Spector**. In the nuts and bolts, I think we are getting a certain amount of standardization.

Mr. **McCandless**. Not figuratively, but using that as a term for down-to-earth, day-to-day activities.

Ms. **Spector**. I am more procurement policy, so that is a little out of my area. I deal with the mechanics of how we buy something once the requirement comes in. I am sure we are looking at what you describe, but it is not in my area.

Mr. **Math**. Theoretically, the common items that are used by more than one service are turned over to the Defense Logistics Agency for support and acquisition. And I think there are efforts, as included in the recent legislation, to assure that when you are acquiring a major system, you determine up front what your common items are, what exists in current systems, and what exists out in the commercial sector to determine whether the weapon system can be supported through that existing mechanism rather than reinventing the wheel, so to speak.

Mr. **McCandless**. Thank you for the additional time, Mr. Chairman. I appreciate that.

Chairman **Hubbard**. Thank you, Congressman McCandless. If you need additional time, no problem.

Mr. **McCandless**. If I may, just a moment.

Chairman **Hubbard**. Sure.

Mr. **McCandless**. In an article that I read, Mr. Math, it talked about the cost of the proposed legislation—with all due respect to my subcommittee chairman, who is very distinguished in his field—that it has been estimated that 3,000 to 4,000 more people would be required to administer the renegotiation as now proposed, and the increased cost to the Government would be at least $100 million annually.

Is that a fair statement?

Mr. **Math**. I can't comment on those numbers, 3,000 to 4,000. We have not done any work in that area recently.

Obviously, the Board has not been in existence for some time. I don't know—we can supply it for the record—but I don't know what the force level was back when the Renegotiation Board was intact.

I think in terms of the reporting mechanism and need for data on a mandatory basis, I think that data is readily available from the contractors. I don't see that there should be an extensive increase in cost to require contractors to furnish information that presumably they furnish to their home offices as part of their normal reporting system and financial reporting system. But I have no figures on the costs or the number of people that would be required to implement this legislation.

Mr. **McCandless**. Both of you, I believe, testified that you felt—at least Ms. Spector did—that the cost/benefit ratio is negative relative to this legislation and what it would produce.

Are you convinced that the steps you are taking that would be consistent with the intent of this legislation will bring about what the legislation is intended to accomplish? Do you have a channel? Do you have a track you are traveling to accomplish these things without the legislation?

Mr. **Math**. In view of the Renegotiation Board legislation, we are basically proposing alternative legislation; we are proposing legislation for the mandatory reporting system and periodic studies. I think through the mandatory reporting system you will have the capability to determine, first of all, the extent of need for periodic studies, and if the periodic studies are not working in terms of setting a resonable profit policy, then you have the alternative to go to something different. If that needs to be a Renegotiation Board or something of that sort, you may have to go there.

But I think we are talking about a determination that regularly obtained through information is to the best approach to addressing profits in their aggregate.

Mr. **McCandless**. Thank you both.

Thank you, Mr. Chairman.

Chairman **Hubbard**. Thank you, Congressman McCandless.

Congressman Gonzalez and I do not have any more questions. We thank you, both Ms. Spector and Mr. Math, for being with us. You make excellent representatives of DOD and GAO, and we appreciate your time and testimony. It was presented in an excellent way.

Secretary Weinberger would do good to send you more often to the Hill, Ms. Spector. You do a good job representing the DOD.

We will now call on our next witness, Richard F. Kaufman, General Counsel, Joint Economic Committee.

I am aware of the time. We are most fortunate we have not been interrupted by rollcall votes. The House began at 10 a.m. We have not had a rollcall vote yet, not even on approval of the Journal.

I am aware that some of you want to think about lunch, but let's see how we progress here. We have an additional panel. We certainly are happy to have you with us, Mr. Kaufman, and we look forward to your testimony.

STATEMENT OF RICHARD F. KAUFMAN, GENERAL COUNSEL, JOINT ECONOMIC COMMITTEE

Mr. **Kaufman**. Thank you, Mr. Chairman. I am pleased and honored to have been invited to present testimony here this morning. I have submitted a written statement.

Chairman **Hubbard**. Without objection, it will be entered into the record.

Mr. **Kaufman**. In the interest of time, I will summarize the statement and try to present the highlights of what I have submitted.

On the basis of the testimony and previous hearings before this subcommittee, I think it is clear that there is a consensus, to the extent that virtually everyone agrees, that excessive profits on defense contracts should not be allowed. It is on the next steps that the consensus breaks down, however.

The real questions remaining are: How do you measure or define "excessive profits;" and how to monitor or regulate them once they are identified?

The plain fact is that of all the secrets of the Federal Government, probably the most closely guarded ones concern defense profits. We probably know more about the CIA and its internal operations, based on news accounts and other reports, than we know about defense profits, and the reason is that the Defense Department simply does not collect information or monitor actual realized defense profits. There is no program in place, to my knowledge.

I think that was alluded to in the earlier testimony for the collection and monitoring of actual defense profits, and it forms the basis of the GAO recommendation that a mandatory reporting system be put into effect.

The real choice before Congress today, in view of the consensus about the need to control excessive profits, is whether this should be done according to an explicit policy under a congressional enactment or in accordance with an administrative policy controlled by the Department of Defense.

What we have today is an administrative system which is under the regulation and control of the Department of Defense.

Congressman Gonzalez' bill urges putting the system back under an explicit law, such as the Renegotiation Act. The Renegotiation Act had three characteristics which are absent under the present system:

First, it contained criteria and standards for determining what excessive profits are. Using the provisions of the Renegotiation Act, one was able to come up with a definition in any individual case as to whether there were excessive profits.

Second, the act provided a system for Government auditors to examine the books and records of Government contractors to determine what their actual profits are, or what they were in any given case.

Third, they provided the authority for the Government to recover excessive profits if there was a determination that they existed.

The Department of Defense says basically to leave the system, the present administrative system, alone. It bases its position on three arguments: First, that renegotiation was not cost effective; second, that the current controls are adequate; third, that there really isn't a problem of defense excessive profits at the present time.

The answers to these propositions are as follows: In the first place, the argument that renegotiation was not cost-effective was first made in the late 1970's at the time the Congress was considering whether to extend the Renegotiation Act. It was an argument advanced principally by the defense contractors and defense contractor associations.

The Department of Defense did not share in the conclusion drawn by the defense contractors at that time. As a matter of fact, the Department of Defense supported continuance of the Renegotiation Act in 1978 and 1979.

The GAO was asked to investigate complaints that there were high costs of compliance. According to one contractor association, those costs of compliance could be as high as $100 million a year. The same figure was asserted this morning. But it should be clear that that was a figure advanced by the contractor community.

When GAO investigated the complaints, they were not able to substantiate the alleged high costs of compliance. After an examination of books and records of a number of contractors who had made specific assertions about high costs of compliance, the Comptroller General, then Elmer Staats, issued a report on September 10, 1977 in which he said the following:

> In general, we have concluded that some costs are necessarily incurred by contractors to comply with Renegotiation Act requirements. We are unable, however, to determine the magnitude of such costs or to what extent they are incremental to other financial data costs.
>
> The primary problem in determining and verifying such costs was that the contractors' accounting systems are not designed to identify and segregate such data.

[The report issued by Hon. Elmer B. Staats, Comptroller of the United States, dated September 10, 1977, referred to by Mr. Kaufman may be found in the appendix.]

The General Accounting Office at the time investigated, for example, allegations of very high costs of compliance by Hewlett-Packard, which was and remains today a major defense contractor. It could substantiate only 10 percent of the costs asserted by Hewlett-Packard.

In another instance involving an allegation by the Teledyne Corp. the General Accounting Office, after an attempt to verify high costs of compliance by that company, interviewed the Government official who, at first, made the allegation—who happened to be a former Assistant Secretary of Defense—and discovered that his allegations were not based on company cost estimates but, rather, were founded on—and this is from the GAO report—"personal experience, intuition, and discussions with members of the Financial Executives Institute."

In short, Mr. Chairman, neither the GAO nor any other independent organization, nor any Government agency, to my knowledge, has ever confirmed the allegations of excessively high costs of compliance with the Renegotiation Board's activities.

Chairman **Hubbard**. Mr. Kaufman, excuse me. We have now a rollcall vote on the House floor, because the House is in session. We have only 8 minutes to reach the floor for the vote.

The practical thing to do at this time is to recess for 1 hour to give us a chance to have lunch, and so we won't come back and try to speed things along. It is not fair to you or the three other witnesses, some of whom have come as far as Florida to be with us.

So we will recess, Mr. McCandless, Mr. Gonzalez.

Mr. **McCandless**. Sure.

Mr. **Gonzalez**. Fine.

Chairman **Hubbard**. We will recess for 1 hour.

The subcommittee now stands in recess. Thank you.

[Whereupon, at 12:30 p.m., the subcommittee recessed, to reconvene at 1:30 p.m., the same day.]

AFTERNOON SESSION

Chairman HUBBARD. The subcommittee now will reconvene.

Thanks to each of you for joining us again, especially to Richard Kaufman, our witness who we had to break off from at 12:30 because of the rollcall vote and taking time for lunch.

Richard, if you can pick up where you left off, or if you want to back up some and take another run at it.

Mr. KAUFMAN. Thank you, Mr. Chairman.

I think I will just continue. I was talking about the Defense Department's argument that the Renegotiation Board was determined to be not cost-effective, and I was trying to clarify the misinformation that exists about that argument.

I think it is important to understand the facts about the Renegotiation Board and its costs, and the costs of compliance imposed upon defense firms for their own sake. But, also, I think it is important to understand that there is a lot of disinformation in this area of defense profits policy. It is a highly emotionally charged subject.

Another factual inaccuracy occurred this morning during the Defense Department's presentation when the Defense Department witness said that the Renegotiation Board itself had estimated that the costs of compliance were $20,000 for each firm subject to renegotiation. That just is not true, Mr. Chairman.

That was the allegation of the defense contractor community which the Renegotiation Board rebutted, because the Board disputed that allegation. The Senate Banking Committee asked the General Accounting Office to audit the contractors who had made the allegations, and I have already summarized what the GAO report concluded.

Let me move then to the second argument of the three that the Defense Department makes; namely, that the present system of administrative controls, together with the legislative authority under the Truth in Negotiations Act and some other laws, are adequate.

It is true that the Truth in Negotiations Act as well as cost accounting standards were intended to place the Government on a more even footing with the defense contractors so far as their costs were concerned. And I think it has done that, to a great extent.

In addition, it is true that the inspector general can investigate areas of wrongdoing and alleged improprieties, and that the Defense Contract Auditing Agency has the authority to audit defense contractors and has a very extensive program of auditing. However, none of these activities are necessarily relevant to the problem of excess profits, for these reasons:

There is no law or regulation that defines what "excessive profits" are. Second, there is no law or regulation that provides the Government, the Defense Department, or any other authority in the Government with the power to reduce a contract price solely because of the existence of excess profits. Third, there is no law or regulation which gives the Government the power to recover or recoup excessive profits if they are identified.

So these authorities under the Truth in Negotiations Act and other laws, and the activities of the DCAA and other contract administrators in the Defense Department are very important but not relevant to the problem of excess profits, because they cannot define what "excess profits" are and they have no authority to deal with excess profits if they stumble over them.

The third argument made by the Defense Department is that there really isn't a major problem. Ms. Spector, in her testimony, asked the question: Are there excess profits? Now, I think that is a very interesting and important question, especially in view of the fact that the Defense Department does not collect information about actual realized profits.

I think the subcommittee might very well ask the Defense Department why, if profits are not excessive—as they assert—does the Department refuse to collect information about actual profits? They have been asked many times to collect this information, and they have not seen fit to go forward with it.

I thought it was a hopeful sign that the Defense Department this morning indicated that they would not oppose a requirement to gather information about actual profits, and I think it would be interesting to put them to the test to see if they would go forward with such a system.

The final point I want to make has to do with the report of the Defense Department that was mentioned this morning, known as the DFAIR report. It is an interesting report, although very difficult to understand because of the introduction of new concepts and new terminology. For example, the term "markup policy" is now being substituted for the term "profit policy."

One then has to read the report carefully to distinguish between markups and markup policy and economic profits and profits. But the term "markup policy" is a very interesting one, because it is the markups in the prices on the spare parts and the other items of equipment that were discussed this morning that has given the Department such a bad time in the press and in Congress.

Now, the argument is made that these are horror cases, that they are exceptional, that they only apply to spare parts, and that the Defense Department is moving to try to deal with this problem. But the argument has also been advanced by defense analysts and some experts from within the Department of Defense that these are not—this is not an isolated set of situations; that the problem of high and excessive markups on defense equipment is a pervasive problem; that it exists with respect to spare parts and it exists with respect to entire weapons systems.

In the 1983 hearings of this subcommittee, a report prepared by the Air Force was placed into the record dealing with Pratt & Whitney. The analysis contained in that report indicated that the Pratt & Whitney facility—which had been studied by the Air Force—included in its prices submitted to the Department of Defense markups averaging over $200 per standard hour of work on defense equipment.

Now, that markup is not entirely unjustified because there has to be a markup in the contractor's costs in order for him to make any kind of fee or profit. But the $200 an hour plus markup in Pratt & Whitney compares with markups from commercial firms doing comparable work of approximately $50 per standard hour, and it has led some analysts to conclude that markups on defense equipment are several times the markups on comparable commercial equipment.

Mr. Chairman, I believe I will stop at this point.

[The prepared statement of Mr. Kaufman follows:]

STATEMENT OF RICHARD F. KAUFMAN

I have been asked to testify about a proposal to reinstate the Renegotiation Act.* My involvement in the subject of defense profits dates from the late 1960's and early 1970's when I participated in hearings by the House and Senate Banking Committees on the Renegotiation Act and the Cost Accounting Standards Board. The Joint Economic Committee, where I presently work, has held numerous hearings on related matters. Most recently, I took part in the 1983 hearings of this Subcommittee on "Defense Contracts: Renegotiation and Related Matters."

The controversy over defense profits goes back to the earliest period of our Nation and will probably be with us so long as there is defense contracting. All would agree that contractors should be allowed to earn reasonable profits. But there is legitimate concern that funds not be used to pay excessive profits. The Defense Department shares that concern and is on record opposing excessive profits. The concensus breaks down over standards for measuring and evaluating profits, and how to regulate them.

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* Mr. Kaufman is General Counsel, Joint Economic Committee. The views expressed are those of the author and not necessarily those of the Joint Economic Committee.

It should be understood that defense profits are and will continue to be regulated. The choice is whether they should be regulated under an explicit congressional policy set out by law, as was the case with the Renegotiation Act, or by administrative policy determined by officials of the Department of Defense. The present system is an administrative one. A central characteristic of the present system is the absence of any statutory or regulatory standards or criteria to determine whether defense profits are excessive. As Defense Secretary Caspar Weinberger said in 1983, responding to a question by Senator William Proxmire, "There are no statutory standards for realized profits."

The bill (H.R. 3020), introduced by Congressman Gonzalez, poses the policy issue, among others, should there be statutory standards for defense profits? The Defense Department's responses to this bill and similar proposals raise factual questions and, before commenting about the policy issues, I would like to say a few things about the facts.

It has been frequently argued that the usefulness of renegotiation is limited to abnormal wartime procurement conditions, that the Renegotiation Board had ceased being cost effective when it was terminated in 1979, that current legislative and administrative controls are adequate, and that defense profits are not excessive. A recent Defense Department study, "The Defense Financial and Investment Review," concludes that the present system is balanced and protects the taxpayer. However, these arguments and the Defense Department's new study are seriously flawed.

1. The Renegotiation Act

The Renegotiation Act was first enacted in 1942, but there were earlier congressional attempts to control defense profits. The Vinson-Tramell Act was adopted in 1934. It limited profits on naval ship and aircraft contracts to 10 percent of the contract price, and was extended to Army aircraft in 1939. An excess profits tax was adopted in 1940. The Renegotiation Act expired at the end of World War II but was reinstated in 1948. President Eisenhower advocated its continuance in 1955 and it was extended as temporary legislation periodically until 1976.

The common premise underlying all these enactments was that there were times when the absence of market competititon would enable some defense contractors to make excessive profits. These conditions could prevail in peacetime as well as wartime. For example, in the absence of competition during peacetime, a seller's market could force the government to pay unreasonably high profits. In fact, some persons believe a permanent seller's market exists in the defense sector because of the high degree of concentration and the monoply or near-monoply conditions that exists in some areas of defense production. In addition, as the General Accounting Office has pointed out, even when there is adequate competition at the time a contract is awarded, conditions may change and result in excessive profits.

Recoveries of excessive profits under renegotiation totaled over $11 billion during World War II. An additional $1.29 billion were recovered from 1954 to 1978. The Board's cost of operations were only a few million dollars annually. Thus, it could boast of savings to the taxpayer many times the costs of its operations.

Nevertheless, it is asserted that the Board imposed high costs of compliance on defense firms. It was alleged in 1978 that these costs amounted to as much as $100 million per year for the defense industry.

The General Accounting Office looked into these allegations by examining the books and records of a number of defense contractors who had complained of high costs of compliance. In his September 10, 1977, report, Elmer Staats, the Comptroller General, said the following:

> In general, we have concluded that some costs are necessarily incurred by contractors to comply with Renegotiation Act requirements. We are unable, however, to determined the magnitude of such costs or to what extent they are incremental to other financial data costs. The primary problem in determining and verifying such costs was that the contractors' accounting systems are not designed to identify and segregate such data.

Hewlett-Packard had claimed unusually high compliance costs amounting to nearly $200,000 annually. GAO was unable to verify 90 percent of the alleged costs. GAO also looked into allegations of Teledyne's Vice President, Barry Shillito, that it cost his firm $20,000 to make filings with the Board. However, GAO auditors were told when they visited Teledyne that Mr Shillito's testimony was not based on company cost estimates, but was founded on "personal experience, intuition, and discussions with members of the Financial Executors Institute." GAO visits to other contractors produced similar results. Two industry associations who had claimed high costs of compliance, the

Financial Executors Institute and the Aerospace Industries Association, refused to supply the names of companies or any details about individual contractors so that they could be audited. In short, allegations of high costs of compliance were not substantiated.

2. Other Legislative And Administrative Controls

Arguments that controls other than renegotiation are adequate to deal with excessive profits usually begin with a description of the Truth-In-Negotiation Act. This act was introduced by Congressman Carl Vinson and was adopted in 1962. According to a recent book on the GAO by Frederick C. Mosher, The GAO: The Quest For Accountability In American Government, Vinson and others who supported the bill felt that defense contractors "were repeatedly stealing from the government by overestimating their prior estimates." The act was intended to put the government on an equal footing with the contractor by requiring him to certify during contract negotiations that costs and pricing data are current, accurate, and complete.

It is true that the government has the right to reduce the contract price if cost data are later determined to have been inaccurate or defective. However, this does not necessarily constitute a safeguard against excessive profits. The government does not have the authority under this act to lower a contract price solely because it is later learned that profits are excessive. The price can only be lowered, under this law, when it is learned that the contractor had given the government faulty information about his costs. If the cost information is accurate, the price cannot be lowered just because the profits turn out to be exorbitant.

Cost accounting standards are similar in effect to Truth-In-Negotiations in that they are designed to enable the government to understand the contractor's costs. When the proposals for the Cost Accounting Standards Board were introduced in the House and Senate, they were intended to require defense contractors to adhere to uniform accounting standards to prevent them from double-charging and triple-charging costs to the government or from otherwise misleading the government about costs. Accounting standards have been useful in helping to identify costs and profits, but they do not empower the government to take any action with respect to defense profits.

Similarly, the Inspector General and the Defense Contract Audit Agency provide useful and necessary services to the Defense Department. But neither office is empowered to take action concerning excessive profits. Thus, if examiners from either group happen to stumble over a situation involving the most extreme case of excessive profits, neither they nor their superiors would have the authority to take direct action.

Indeed, under present circumstances, as the quote from Secretary Weinberger suggests, there are no statutory standards or other criteria for determining excessive profits. The weighted-guidelines method provide an approach that defense contracting officers use in calculating profits during negotiations. But the weighted guidelines do not say what a reasonable return is or what an unreasonable return is. One cannot come up with a definition of reasonable or excessive profits using the weighted guidelines.

3. DOD Profit Studies

A curious aspect of the defense profits controversy is that the more studies and reports we get from the Defense Department the less we seem to know about the subject. One problem is that defense officials, on occasion, have given inaccurate and misleading statements. For example, last year, Mary Ann Gilleece, Deputy Under Secretary for Research and Engineering, Acquisition Management, testified before this Subcommittee in hearings on Profits on Defense Contracts. In her testimony, Secretary Gilleece, referring to an earlier Defense Department study, called Profit '76, said "the major findings of that study were that profits on defense work were lower than those being earned in the commercial market place by durable goods manufacturers, both as a percent of sales and as measured by return on investment." This was a misreading of the report. The report actually found that profits on defense work, as a return on investment, were higher than what was earned in the commercial marketplace. Deputy Secretary of Defense William P. Clements acknowledged the correct finding when he appeared before the Joint Committee on Defense Production, November 18, 1976. Mr. Clements said on that occasion that the Profit '76 report showed, "defense contractor profits, when measured on the basis of sales, are on the average lower than those generated in commercial endeavors; however, when measured on an investment basis, they are somewhat higher."

Defense studies have also been, at times, inconsistent and somewhat contradictory. Secretary Clements found in the Profit '76 study that there was a low level of investment by defense contractors, and that on the basis of sales dollars, commercial firms on the average were investing more than twice the amount that defense contractors were investing in production facilities. He concluded that profit policy needed to be modified to create a greater incentive for investment and to improve productivity. Profits were increased as a result of that study.

Several years later, the Air Force conducted a study entitled, "Profit Study '82," to evaluate the effects of the policy changes. In its study, the Air Force asked these questions:

- Has the profit policy stimulated investment in contractor facilities capital within the defense industry?
- Has the profit policy rewarded productivity improvements generated by defense contractors?

After pointing out that profits had increased in recent years, the study reached the conclusion that the changes had not produced the desired results. It found that capital investment within the defense industry had increased, but that it was still proportionately less than in the commercial sector. As a percentage of total cost, capital investment did not change during the 1977-1981 period, according to the study. The study concluded, "thus, the assumption that higher return on sales will stimulate investment on defense contracts was not supported by actual experience. Profits were higher during 1977-1981, but relative investment did not change." The report went on to say that it doubted that the capital employed profit factor has had any influence on contractor investment decisions.

The most recent Defense Department study, "Defense Financial and Investment Review," takes issue with some of the findings in the Air Force study and seems to at least partly disavow it. It disputes the Air Force finding that the capital employed profit factor has not motivated contractor investment, saying that significant contractor investment has occurred, but conceding that the rate of change in capital investment has been driven by factors other than defense profits policy, which it now terms "mark-up policy." The DOD study also says that mark-up policy, in and of itself, is insufficient to bring about productivity-enhancing improvements.

Partly because of the introduction of new terms such as mark-up policy, and the use of concepts such as "economic profit," the new defense study is in many respects vague, obscure, and unneccessarily complicated.

More importantly, this report, as was the case with its predecessors, fails to present and adequately discuss the facts about actual, realized profits. Secretary Weinberger acknowledged two years ago that the Defense Department simply does not collect data or issue reports on actual profits realized in defense contracts. The Defense Department does collect data on negotiated profit rates. These are known as the going-in profits because they are the rates agreed upon when the contract is awarded. The actual profits are what the contractor realizes when the contract is completed. Actual profits are known as the coming-out rates. The significance of this distinction is that the coming-out rates can differ greatly from the going-in rates. It would seem elementary that the Defense Department would monitor both the negotiated going-in rates and the actual coming-out rates.

Senator Proxmire placed into the record of the 1983 hearings the DOD negotiated profit reviews for the years 1977-1980. At that time, defense officials stated that the reports for 1981 and 1982 had not yet been completed. I am now informed that the Defense Department has stopped issuing these annual reports altogether, although it still collects and analyzes the data. It was hoped that the new DOD study would contain a full discussion of actual as well as negotiated profit rates. Last year, Under Secretary Gilleece, in a discussion of the DOD study then in progress, stated "we are also, by the way, looking at the feasibility of establishing a regular feedback and monitoring system which will enable us to track the actual profitability of defense work and thereby preclude the need for future studies but always have at our fingertips that particular system." The new defense study is largely based on information voluntarily submitted by 76 defense contractors plus negotiated profits data, and can hardly be a foundation for a monitoring system to track the actual profitability of defense work.

4. Policy Issues

GAO has recommended, as an alternative to renegotiation, a requirement for periodic profits studies. In the absence of information about actual defense profits, it would not be possible to satisfactorily monitor defense contractor profitability. In any event, one can question the adequacy of periodic reporting as a defense profits policy.

The advantages of renegotiation are that, under such a system, government auditors are able to obtain information about actual profits and there are criteria for determining what is excessive. Even if the Defense Department began collecting information about actual profits, the situation would fall short of renegotiation in that the Defense Department would still be unable to either define excessive profits or take direct action when they are identified.

Defense officials ask whether there are excessive profits. The answer is that it is not possible to quantify the magnitude of the excessive profits problem because neither the Defense Department nor anyone else collects verifiable information about actual profits. But there is a considerable price mark-up problem, as indicated by the many recent disclosures of exorbitant prices on spare parts. Other problems, ranging from overcharges on overhead and apparent conflicts of interest by high defense procurement officials, have also been recently documented. One might ask the Defense Department why, if profits are not excessive, does the Department refuse to collect information about actual profits?

The questions that remain for Congress to answer can be divided into two categories. The first is, does Congress want defense profits to be monitored and, if so, who does it want to do the monitoring and at what level of detail? The second category of questions is, does Congress want defense profits to be regulated and, if so, how should excessive profits be defined, what actions should be taken against contractors who obtain excessive profits, and who in government should take action?

Chairman HUBBARD. Thank you.

Mr. KAUFMAN. I would be happy to answer any questions from the committee.

Chairman HUBBARD. You are not concerned that the contractors are making a profit; just that they are allegedly making excessive profits. Is that right?

Mr. KAUFMAN. That is correct, Mr. Chairman. I think there is a very broad consensus, as I indicated at the outset of my remarks. One part of that is that excessive profits should not be allowed; that the taxpayer should not have to pay excessive profits for equipment purchased from the Government.

But the other side of that consensus is that reasonable profits should be allowed, and not only are they necessary, they are desirable, as was testified to earlier.

Chairman HUBBARD. Does it make you less concerned about excessive profits on defense contractors to know that GAO sent auditors into 10 of these top 50 arms suppliers to perform audits to see if there has been fraud or excessive spending by the Government?

Mr. KAUFMAN. Well——

Chairman HUBBARD. Does that satisfy your concerns?

Mr. KAUFMAN. Well——

Chairman HUBBARD. As a start?

Mr. KAUFMAN. The resumption of defense contractor audits by the General Accounting Office is a very important new development in that agency's activities. I have confidence that they will come out with important information as a result of the audits that they have initiated. But those audits are not relevant, so far as I understand, to the excess profit problem.

They have gone in to look at problems of defective pricing and some other questions that they have. But in order for any auditor to discover what profits have been earned on any contract, there has to be a special kind of an audit.

Chairman HUBBARD. What about the Defense Contract Audit Agency?

Mr. KAUFMAN. The Defense Contract Audit Agency does not look at contractor profits. They audit costs. And one of their principal concerns is to satisfy themselves that there is not a defective pricing problem. But they rarely, if ever, look at the actual realized profits upon completion of a contract.

Chairman HUBBARD. How about the newly created Commission on Defense Management?

Mr. KAUFMAN. It would be very interesting if that commission undertakes to look at profits policy. I am not aware, from any of the statements made by the chairman of the Commission or by reports in the press, that that is even on their agenda.

Chairman HUBBARD. What would be, in your opinion, the cost of reestablishing the Renegotiation Board?

Mr. KAUFMAN. Well, I think——

Chairman HUBBARD. As a guesstimate?

Mr. KAUFMAN. In its last year of operation, Mr. Chairman, the Renegotiation Board spent $6 million. They had approximately 175 employees on their payroll. It would depend——

Chairman HUBBARD. You agree that in this day and time, it would take a whole lot more than $6 million per year to reestablish the Board?

Mr. KAUFMAN. Well, in the first place, if you put $6 million a year in current prices, even that amount would have to be enlarged to be realistic in view of the inflation that has taken place since 1978.

Chairman HUBBARD. How can you convince a person such as myself, who has a very conservative district where the No. 1 issue is the Federal debt and deficit spending, and whose constituents voted for President Reagan, because he promised to lessen the Government spending, or reduce Government, and they voted for him again thinking he was trying—how do I convince them that what we need is another Board?

Mr. KAUFMAN. Well, Mr. Chairman, in the first place, it is true that those promises were made. The record shows they have not been kept, so something has gone wrong. And you cannot blame the Renegotiation Board, because they went out of business before President Reagan came into office.

Chairman HUBBARD. I blame Congress, frankly.

Mr. KAUFMAN. But let me answer more directly, Mr. Chairman. I think there is a misconception here about the nature of an enforcement agency like the Renegotiation Board. One could also ask a similar question about the Securities and Exchange Commission and the IRS, as to whether it is necessary to have such a large regulatory and enforcement agency; and wouldn't it save money if we eliminated them?

Chairman HUBBARD. Wouldn't you agree that at this time the news media and the Defense Department are both trying to find the excessive spending by the Defense Department?

Mr. KAUFMAN. I think so.

Chairman HUBBARD. The Defense Department doesn't reveal it, but the press does, when they know about it.

Mr. KAUFMAN. I think both Congress and the news media have done an excellent job in scrutinizing defense programs and spending activities and uncovering questionable activities and areas of waste, mismanagement and even fraud.

I am not satisfied, speaking as a taxpayer, Mr. Chairman, that the Defense Department has enthusiastically or wholeheartedly yet joined in this effort.

Chairman HUBBARD. Has it been proven for sure that there have been excessive profits by certain contractors?

Mr. KAUFMAN. In the period when the Renegotiation Board was in business, there were findings of excessive profits, and there were many voluntary agreements with defense contractors to refund the Government because of excessive profits. But it is a catch-22 type of question to address today, since there is no definition of "excessive profits," on the one hand, now that the Renegotiation Act is in suspension; and second, since the Defense Department does not collect information about profits, it is impossible to know the magnitude of the problem.

Chairman HUBBARD. Or if there is a problem. But you would want to establish a new board just to try to determine that?

I mean, the $6,000 coffeepot gets a lot of jokes on TV, and Johnny Carson can use that in his one-liners. But you have someone like Congressman McCandless, who complains why that particular coffeepot has to cost that much because of the delicacy of construction for use in our Air Force planes.

That makes altogether good sense, but still you have the one-liners about the $6,000 coffeepot.

Mr. **Kaufman**. The explanation that these excessive prices are due to unrealistic and excessive design requirements put into the equipment may be correct, in some cases. But it is an incomplete explanation for at least one reason, and that is that the defense contractors themselves frequently are the ones who provided the design requirements to the Government, and they are very often built to the contractor's own specifications.

It seems to me, Mr. Chairman, that as the Defense Department stated this morning, one of the advantages of having a board or an agency or an office with explicit statutory functions to perform in the area of excessive profits is that it provides the public with the confidence that the problem is being addressed.

Chairman **Hubbard**. The public wouldn't have confidence in their own Defense Department or the GAO or the DCAA or newly created Agency on Defense Management. My constituents don't criticize any of the four I just mentioned. They are not begging for a new Board—that is for sure—of any kind.

Mr. **Kaufman**. One of the premises that underlie the establishment of the Renegotiation Board was that it was an important factor to have a civilian agency independent of the Defense Department to take an outside, objective look, uninfluenced by self-interests.

Chairman **Hubbard**. Who would you have appointing these people to this Board? I am unfamiliar with who appointed them before.

Mr. **Kaufman**. Under the Renegotiation Act, the members of the Board were all appointed by the President.

Chairman **Hubbard**. For how many years?

Mr. **Kaufman**. They may have had fixed terms, possibly at 5 years. But I would want to provide that information for the record.

[The following information was submitted for the record by Mr. Kaufman:]

Under the Renegotiation Act, members of the Board were appointed by the President and served at his pleasure. At the time of the demise of the Board, pending legislative proposals provided that members' terms be fixed at 5 years.

Chairman **Hubbard**. Congressman McCandless.

Mr. **McCandless**. Thank you.

If I understand your testimony correctly, you are saying in essence that we need to have this kind of an organization. Did I understand you correctly?

Mr. **Kaufman**. Congressman, in view of the consensus that it is important to eliminate or avoid excessive profits on Defense Department contracts, I believe the logic of the situation does lead to a conclusion that an independent civilian office, agency, or board, would be best suited to perform that function.

Mr. McCandless. And that the alternative available as you describe in your first remarks prior to lunch, administratively you don't think that the same kind of activity could be done as well? You outlined the fact it could be done administratively or done by legislation.

Mr. Kaufman. One could conceive of an administrative system that would have most of the elements of what I would call a statutory system.

By regulation there could be a definition of excessive profits; a group could be established with authority to audit contractors and collect information about actual profits; and to take action with respect to any contractor whose profits exceeded the standards.

Now, I believe some legislation would probably be needed to authorize the Defense Department to actually recover excessive profits, but most of those elements could be built into an administrative system.

Mr. McCandless. Would you comment a little bit about this. We are talking about an auditing process to accomplish an objective which we are here to talk about. That auditing process goes on in virtually every agency and section of the Federal Government in some form or another, depending on the mission of that particular agency or department.

Yet, we are saying here because this is the Defense Department that we need to have—there is a proposal to have, that is, this separate system and so one could possibly draw a parallel and say, well, we need something like this over in Social Security because of the tremendous number of dollars that take place there, and the tremendous number or cases in order to ensure, a, b, c, d, e, and f or we could go to some other large department or agency of the Federal Government, and isn't this a responsibility of the management of the agency to set up the necessary framework by which that agency functions properly and gives the taxpayer the biggest bank for the buck?

Mr. Kaufman. It is, Congressman, if that is what Congress wants done.

Mr. McCandless. Well, you don't have to go down to Health and Human Services and get a legislation package to go out and check records or to do something that is going to enhance the image of and make the dollars of the Health and Human Services budget go farther.

That is something that can be done administratively, can't it?

Mr. Kaufman. Yes, it can, but let me respond in two parts.

To answer that last point, it is true any government agency has the inherent authority to satisfy itself that funds are being used properly and efficiently and to collect the information necessary in order to create that assurance, including information from individuals and private contractors that it deals with.

The Defense Department has that inherent authority. The curious thing is that the Defense Department has refused for many years to go out and collect information about actual profits. Now, they used to collect information and issue reports on negotiated profits. These are referred to as the going-in profit rates that are negotiated into contracts. They were issued as annual reports up to 1980.

Since 1980 the Defense Department has not issued any more annual reports even on the negotiated profit data that I understand is still being collected.

Mr. McCANDLESS. If I may, let me stop you there. Was this a beneficial endeavor with all the man-hours and efforts, did they stop it because it was counterproductive or because of this or that? Why was it stopped if it is so important?

Mr. KAUFMAN. My understanding is that they have not stopped the program of collecting and analyzing information about negotiated profits. What they have stopped doing is making it available to Congress.

Mr. McCANDLESS. We still have the management of the agency, the Secretary of Defense and his Under Secretary, and Assistant Secretaries responsible under the Constitution to carry out the office which they have been placed in, so we are saying that because it is not made available to Congress, the implication is that if there is excess profits and they are shown in these reports which are no longer made public, that this excess profit is known to those who have the responsibility of managing the Department.

Is that an assumption that is correct?

Mr. KAUFMAN. I assume that the top management of the Defense Department is aware of or has access to that information. But one can at least speculate about the reasons why they stopped providing it to Congress. In the 1983 hearings of this subcommittee, the annual reports on negotiated profits for the years 1976 through 1980 were placed into the record, and they are part of the printed hearings.

Those reports showed an upward trend in negotiated profits. If one looks at the recent studies conducted by the Air Force in 1982 and the one issued by the Defense Department this year, one can see in the tables and charts that this trend has indeed continued since 1980, but what one doesn't see is the breakdown in terms of profits for each of the services, for types of contracts, for categories of products.

So it is possible to conclude although I wouldn't want to do it definitively, but one could conclude that the reason the information is no longer made available is because it might prove embarrassing to the Department of Defense.

Let me get to the second part——

Mr. McCANDLESS. Hold on, let me interrupt you here.

You are saying then that there is some kind of a curve on a chart if we were to draw it wherein commodities in question have an increased profit to the vendor over a period of the time in question and that I as the Assistant Secretary or the Under Secretary or the Secretary look at this chart and say that, well, back in 1980 the profit on that was this and here it is 1984 and the profit is this plus, and that is OK.

Do I understand you correctly?

Mr. KAUFMAN. I am not sure what conclusion the Secretary would make.

Mr. McCANDLESS. Well, that the Secretary of Defense or whoever is looking at this theoretical chart that you and I are talking about, you are saying that it is all right to have this upward curve in additional profits if we are comparing apples and apples and oranges and oranges, if we are taking it overall, all defense expenditures.

I don't think you can arrive from my point of view, I believe, at a rational judgment on this. But if you are taking how much profit was on a sidearm in 1982 and then how much percentage profit was for 1984 and the profit jumped, 5, 10, 15, 20 percent, and it is the same sidearm and didn't require research and development and other things that could go into the profit, then it would appear that those in charge would say, hey, we are paying too much for this because it is the same commodity even though the cost to manufacture has gone up, the profit range increased.

Mr. KAUFMAN. One would hope that that kind of reaction would occur. But one doesn't know because the information isn't available any longer.

Mr. MCCANDLESS. I agree with you, I believe that excess profits should not be a part of the scene. I cannot argue there. I believe a reasonable profit is in order, so my discussion with you is not to challenge that aspect of your presentation, but to simply say that I think a certain amount of trust must be placed in members who are appointed to important positions to manage those agencies and departments correctly, and that if in fact they are not being managed correctly—and I am using general terms now—for whatever reasons, profits or whatever, that that should be the point and that is the point at which the finger should be pointed and not so much let's find a solution to it in some legislative act.

Thank you, Mr. Chairman.

Mr. KAUFMAN. Could I respond quickly to the second part of your original question, because it is an important one and that is, Why select out the Defense Department for unusual treatment in reviewing its profits on its contracts?

One reason of course is that there is a lot of attention on the Defense Department because that is where a lot of the money is. In terms of contracts, something like three-fourths of all contracts awarded by the Federal Government annually are ordered by the Department of Defense. As a matter of fact, the Renegotiation Board had jurisdiction over some other agencies in addition to the Defense Department.

It had jurisdiction over some activities of NASA, for example. I do think that a logical argument can be made that if there is agreement that excessive profits should not be permitted on Government contracts, that we ought to look at all Government contracts and not just those of the Department of Defense.

Mr. MCCANDLESS. Thank you, Mr. Chairman.

Chairman HUBBARD. Just a question immediately following Congressman McCandless' line of questioning. The Department of Health and Human Services, to which Congressman McCandless referred, spends multibillions of dollars each year of Federal tax dollars. Would you favor creating a new board or new watchdog agency to investigate their spending for possible waste and abuse?

Mr. KAUFMAN. As I understand the legislation that has been introduced by Mr. Gonzalez, it deals first with Government contracts and specifically——

Chairman HUBBARD. I believe you missed—passed the opportunity to say yes or no to my question, but go ahead.

Mr. **Kaufman**. Well, the short answer is "No." I would not favor creating new boards or agencies to scrutinize the spending activities of——

Chairman **Hubbard**. Except as to national defense?

Mr. **Kaufman** [continuing]. Of all Government agencies.

What I am saying in this particular area of defense is that there is a good reason for being concerned about excessive profits on defense contracts. Now, the Social Security Administration does not award that many contracts. What they do is distribute money to the Social Security beneficiaries from the trust funds that are held by the agency.

If Congress is concerned about whether any other Government agency is allowing unreasonable, exorbitant or excessive profits on its contracts, then I do think that that agency should receive some attention.

Chairman **Hubbard**. You see, my point is this: If we had an agency that looked into waste, fraud, and abuse as to the Department of Health and Human Services or of other agencies, we would be creating more and more bureaucracy and they would be trying to do what we have appointed the different executives who head those agencies to do.

Congressman Gonzalez.

Mr. **Gonzalez**. Mr. Chairman, I will just say this because Mr. Kaufman has been here since this morning.

I have a mix of amusement and shock if my two distinguished colleagues, the chairman and the distinguished gentleman from California, Mr. McCandless, were trying to say that you are going to put a food stamp recipient on the same footing with General Dynamics. If you want to know how well they audit food stamp handouts, let me take you to my district where I have visited a good many and just to be barely eligible for 10 dollars' worth of food stamps a month, they are really audited.

Mr. **McCandless**. Will the gentleman yield on that point?

Mr. **Gonzalez**. The idea that you equate the Department of Defense procurement system and a need to audit the negotiated contract area, with the activities of the Social Security Administration, is just so preposterous that I just don't know what to think.

Mr. **McCandless**. If the gentleman would yield.

Mr. **Gonzalez**. I think my two colleagues missed the point of the whole need for the legislation, and I don't know how you can reasonably, along this line with this kind of questioning that is so absurd that I just cannot see ourselves wasting the time of witnesses.

Certainly I yield.

Mr. **McCandless**. I tried to make a point here not so much that food stamps are not audited or something else is, the point I was trying to make was it is the basic inherent responsibility of management and a given agency, whatever it may be, to function in those fields of administration.

Mr. **Gonzalez**. Of course.

Mr. **McCandless**. Of course, of which procurement and procedures around the procurement process are developed in a manner that the procurement process is carried off in a satisfactory way. It is a basic management requirement and I——

Mr. **Gonzalez.** Of course. We take that for granted. We take for granted that the average citizen of us will be law abiding, we won't be going out to murder anybody. But we have to have laws against murder. We are not writing laws to be administered by angels, even if everyone is trying to do his duty under the law.

We are human beings, subject to all the foibles and frailties of human beings. That is why we have the horror stories and all that. We live in a day in time when you say, well, we realize we were sinning and now we are reborn believers in God and God has forgiven us and I sure wish we had not sinned, but if I did I did it to protect my stockholders' margin of profit, or income, or whatever.

I mean, we cannot sit here and get into these sort of wasteful discussions about trying to compare the needs for surveillance and accountability with one agency with another, when we are talking about a specific need that has become quite obvious in the last year or two.

So this isn't—this specific bill, I have never known of a bill that is perfect and I certainly wouldn't claim any kind of authorship along that line, but then what is our suggestion as an alternative?

I am not trying to say that we are for—nobody is for creating needless boards. That is not the issue, Mr. Chairman. I think that when we start equating these things with HEW or what used to be HEW and food stamp recipients, Social Security beneficiaries, I just think we are way astray.

I don't have any questions, Mr. Kaufman, because I think the record and your testimony brought out most of what I would have anticipated by way of a question. I want to thank you very much for taking time to be with us.

I know you have been away from your work since this morning early. Thank you, Mr. Chairman. We will come back if you are going to recess.

Chairman **Hubbard.** Thank you very much, Chairman Gonzalez.

Thank you, Richard Kaufman, General Counsel of the Joint Economic Committee for being an excellent witness at our hearing this afternoon.

We appreciate your time and your testimony.

Mr. **Kaufman.** Thank you, Mr. Chairman.

Chairman **Hubbard.** We will now recess, but would William R. Tolley, Richard G. Mulligan, and Donald S. Grenough please come to the witness table and be ready for us when we reconvene in about 10 minutes.

We now stand in recess.

[Recess.]

Chairman **Hubbard.** The subcommittee will now reconvene.

We not only had a vote on a crucial amendment, but we had a final passage vote also. That explains why Congressmen Gonzalez, McCandless, and I are returning later than we indicated as we went into recess.

We now have our last panel.

Bill Tolley is director of legislative affairs for Harris Corp.; Bill is from Melbourne, FL. The corporate offices are here in Washington. We appreciate his being here, along with his lovely wife Pat Tolley.

Richard G. Mulligan, Dick Mulligan is chairman of the committee on government business, Financial Executives Institute here in Washington. Is that right, Dick?

Mr. MULLIGAN. The committee operates from Washington, right.

Chairman HUBBARD. We are certainly glad to have you as chairman of that committee. And Donald S. Grenough, partner with Touche Ross & Co. in Washington.

Mr. GRENOUGH. Yes, sir.

Chairman HUBBARD. I am happy to hear that Mr. Grenough is originally from Louisville, KY.

Mr. GRENOUGH. Yes, sir.

Chairman HUBBARD. Graduate of St. Xavier High School and the University of Louisville, which is my alma mater. We are glad to have you three. We will call on Bill Tolley to be our first witness on this last panel of the day.

You may proceed.

STATEMENT OF WILLIAM R. TOLLEY, DIRECTOR OF LEGISLATIVE AFFAIRS, HARRIS CORP.

Mr. TOLLEY. Thank you, Mr. Chairman, and members of the subcommittee. I am pleased to be here this morning to talk to a subject that I have had a lot of interest in over a number of years.

I will only cover part of my prepared remarks, and I would like to touch on some issues that came up in an earlier panel.

Chairman HUBBARD. Without objection, the prepared testimony of the three of you will be entered in the record regardless of your shortcomings.

Mr. TOLLEY. Thank you.

Just as a matter of insight, Harris Corp. which has $2.3 billion of annual sales, is about 40 percent Government sales. That doesn't mean Government contracting in the traditional sense, but it is certainly that proportion of our sales for Government end use products, 60 percent being commercial.

Mr. Chairman, as you know and many others on this committee know, the issue of the Renegotiation Board was debated at great length during the 94th, 95th, and 96th Congresses. The result being that the Board was terminated in 1979.

Subsequent to the termination of the Renegotiation Board, Congress dealt with another profit restriction law, that being the Vinson-Trammell Act. Like the Renegotiation Board, the Congress terminated the Vinson-Trammell Act, an act affecting military aircraft and naval vessels that lay dormant because of existence of the Renegotiation Board.

There are many reasons that these two laws were rejected by Congress, but I believe there is one overriding reason that both were turned down. That reason is simply that profit limitations do not work.

In the past, proponents of profit limitations have raised numerous issues to justify the imposition of such limitations. Many of these reasons sound convincing, as you heard this morning and this afternoon, and play well in the media, however when examined in an objective light, they fail to demonstrate how profit limitations will solve the perceived problems. On the other hand, it is quite clear as to how profit limitations negatively impact the interests of the U.S. Government, U.S. business, and taxpayers as a whole.

Let me use a very straightforward, simplified explanation of how profit limits are negative.

Let's consider for a moment, Mr. Chairman, that each of you on the committee, is a building contractor and I am a customer who desires to have a home constructed. So I come to you and ask for a bid and I may get bids from other contractors as well.

After receiving the bids, I have chosen you as the one to have the best price for the quality of the home and the product, so we enter into a negotiation, we agree on all the materials to be involved, the layout, all features of the house and agree on a price.

Then I, as the customer, say; "There is one other small thing I would like to add into this contract, and that is—if your profit on costs exceeds 10 percent, you must return all of the excess to me."

So you, being a prudent contractor, having agreed to this, and using the arbitrary $100,000 price for this contract, you evaluate the deal. The deal now would suggest that if you can perform this for $60,000 that you earn $6,000 worth of profit. If you do it for $70,000 you earn $7,000 and so forth.

Your only conclusion will be that the most, the best cost for you to incur is that cost, when 10 percent is added, is exactly $100,000.

So as a good businessman, you should strive to reach that optimum point. That maximizes your profit and gives me what I want. However, if I am the U.S. Government and I am saying the same thing to you, I am in fact losing on the deal because as a U.S. Government, I collect taxes on that profit, so I should want to incentivize you to the lowest possible cost and indeed, if you can perform that for $50,000 and make $50,000 worth of profit, then half of that is returned to me through taxes.

So I, as the U.S. Government have a better deal than as an individual when profit is increased.

Probably in the long range, though there is another more significant reason why it is bad for the U.S. Government. That is if I wanted an additional house constructed and you had a much lower cost basis to work from on an experience basis and you had gained efficiencies because of the profit motivation, then when I come back for that second proposal, the follow on bid, you are starting from a much lower cost basis from which to bid to me the next time.

If I am aware of that, then my negotiations strength will be stronger. This process of getting the information, negotiating the follow-on contracts is where the truth in negotiation comes in, and is very operative in that environment.

So I think from a fundamental standpoint, it is most appropriate to leave the profit incentive out there and to leave that with the contractor.

The greatest cost impact of profit limitations, be it renegotiation or whatever, is the insidious impact on cost. It is that part that is not measured in any studies I have seen and that is the cost inefficiency that profit limitations place in the contracting arrangement.

Mr. Kaufman, in his statement, said that there was a consensus agreement that excessive profits should not be permitted. I think there is a larger consensus agreement that excessive prices and excessive costs should not be permitted. So, I think we are dealing with the level of priority and I would submit that the largest concern of the U.S. Congress and the Government is the total price that is being paid. Therefore any consideration of excessive profits controls and constraints must be subverted in the interests of the larger issue, and that is the ultimate cost of the product to the U.S. Government.

In short, if the pot at the end of the contract rainbow is for the supplier to pay back to the Government the fruits of excellence, then mediocracy is rewarded and excellence is discouraged.

To further elaborate on that point, I recommend for your reading a real live saga entitled "A Grim Fairy Tale." This is a statement by National Presto Industries, Inc. in hearings before this committee in 1977, and I would be pleased if you would like to provide that for the record to be included.

Chairman Hubbard. Without objection, so ordered.

[The statement by National Presto Industries, Inc., submitted for the record by Mr. Tolley follows:]

STATEMENT OF THE NATIONAL PRESTO INDUSTRIES, INC., JOSEPH H. BERNEY, VICE PRESIDENT

"A GRIM FAIRY TALE"

Once upon a time, there was a company that believed that Government contractors who took risks and who were efficient would be rewarded. The company's name was Presto. Now, Presto usually sold pressure cookers and other useful things for the kitchen, but in times of need it also produced projectiles for the Army; 1966 was such a time of need and the company offered its services to its Government.

The company, in accordance with its belief, took lots and lots of risks. In 1966, in the face of some very long odds, the company decided to produce 105-millimeter projectiles. The Government equipment on which it was to produce these projectiles had been installed in 1954 and most of it had never been used. Naturally, all of the equipment warranties had expired by 1966. The equipment had been specially designed for a new largely untried process called, "hot cup cold draw." No one had ever tried to use the hot cup cold draw process for mass production.[1] Since most of the equipment had not been used, it was unclear whether the process would really work. The equipment had also been designed to produce a 1953 projectile. To no ones surprise the 1966 projectile was not the same as the 1953 projectile. In 13 years one would expect the Army to have made lots of changes. Consequently, the untried equipment designed to use an untested process to produce a 1953 projectile, had to be modified to make the 1966 model projectile.

Sounds pretty risky, doesn't it. That's not all, in fact, many would say that was the least of Presto's problems. There was the matter of people. Who would manage the projectile lines? Who would supervise the lines? Who would man the lines? In 1966 there was no one to do these jobs. Naturally, Presto had first-class management and engineering talent, but that talent was busy developing better pressure cookers and thinking up new kitchen items like the first submersible electric coffee pot and the first electric fry pan.[2] Finding good management talent was next to impossible: persons of ability are only interested in jobs that have long-range opportunity. Managing a shell line is at best a temporary affair, since the Army's need for projectiles is usually very short term. Finding enough people to man the lines was also no easy task. For one thing the labor market in 1966 was tight. For another, the lines were located in Eau Claire, Wis. Eau Claire may be the metropolis of northwest Wisconsin but its population, at least in 1966, was less than 40,000. A minimum of 2,500 people were needed to fully man the projectile lines. Mind you, many of the jobs required the skills of an electrician, of a millwright, and of a mechanic.

The people problems were eventually solved. Presto diverted its best management, manufacturing, engineering and procurement people from their commercial tasks to projectile production. It went on an areawide search to find people to man the lines and did a great deal of on the job training.

Presto took yet another risk. Against the advice of the true steel experts, the steel companies, it decided to use a relatively low grade of steel that was considerably cheaper than the steel which the steel companies recommended for the hot cup cold draw process.

Did these risks pay off? Yes and no. On the one hand, Presto went through a minor hell to reactivate the shell lines; its commercial business eventually began to show the effects of neglect. On the other hand, the low grade steel worked (the steel companies were wrong) and the company managed to earn profits on its contracts.

Were these the "only" risks that the Company took? Hardly, because once the Company began to produce, it produced and produced and produced. And that created more risks.

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[1] The hot cup cold draw process is a real money saver but it's hideously complex and very difficult to implement. Most companies that have tried to use it have failed, taking some very hefty losses in the process.

[2] That same talent has recently brought you the Presto Burger TM hamburger cooker and the FryBaby TM deep fat fryer.

By the middle of 1968, the Company was averaging about 1,000,000 105MM projectiles per month. That is a lot of projectiles. The competition could not keep up, and while their prices began to climb during the inflationary period of the late 60's, Presto's dropped. Finally, in the latter period of 1969, when there was nearly a 30 percent price spread between Presto and its nearest competitor, the competition dropped out.

As the Army's only 105MM producer, Presto continued to pour out shells at the rate of 48,000 per day—that's 1,000,000 per month. The Army did not need so many projectiles, but since the price for one million was about the same as the price for the amount per month that the Army really needed, the Army felt that it could not pass up the bargain. So the Company produced and produced. Naturally, the equipment began to get very, very tired and breakdowns became more and more frequent. But still the Company produced and produced.

Suddenly, in early 1972, one million shells per month wasn't enough. The Army needed more projectiles for the Tet Offensive. To obtain more projectiles, it would have to either reactivate one of the other 105MM plants—a very expensive and time consuming operation, or ask Presto to produce additional projectiles on equipment that was already showing severe wear and tear.

Presto responded by running its lines around the clock, six and sometimes seven days a week. The equipment was denied its Saturday and Sunday Sabbath, days during which routine maintenance (and sometimes not so routine maintenance) had been performed. Equipment breakdowns became even more frequent. Nevertheless, Presto managed to boost its production from 48,000 projectiles per day to 51,000 projectiles per day, to 53,000 projectiles per day and finally to 54,000 projectiles per day. Thanks to Presto's extraordinary effort, the Army had enough 105MM projectiles for the Tet Offensive, and it didn't have to reactivate another 105MM facility.

Now, you might ask, what the risk was in producing projectiles on tired equipment. Surely, you might think, the Government would compensate Presto for any losses resulting from the breakdown of equipment. Well, if you think that, you are wrong. All of Presto's contracts with the Government were fixed price contracts. Under a fixed price contract, the contractor receives the contract price no matter what happens. If a key machine breaks down, it is Presto who pays the workers for their idle time, and it is Presto who bears the cost of the unabsorbed burden—the contract price remains fixed whether Presto produces 200,000 projectiles per month of 1,000,000 projectiles per month.

Fixed price contracts are always risky contracts. Fixed price contracts with the Army are riskier than any other fixed price contracts. Like most other contract negotiators, the Army negotiators are tough and always seek to negotiate the lowest possible price. Unlike most negotiators, the Army has access to all of the information the contractor uses to calculate its price, in fact, it even audits all of the historical cost data.

Not only that, but the Army gets a second bite out of the apple. At the end of the contract, it performs a second audit. If it finds that the contractor did not reveal "all" during the negotiations, it may take away the profits that it believes would not have been realized had the contractor shared all of its knowledge. Clearly, the Army is in a unique position to drive a very hard bargain.

Presto not only took lots of risks, but was also very, very efficient. Believe it or not, that exhausted equipment is still running. Presto has used it to produce 92,376,129 projectiles (and still counting). That is more heavy artillery projectiles than has been produced at all other (105MM, 155MM, 8 inch, etc.) facilities combined. The prior production record for a single facility was 44,000,000 a performance that had been considered extraordinary—a never to be attained again performance. The equipment on the other line is to be completely replaced, for in the process of producing a mere 44,000,000 projectiles, the lines were totally consumed and the equipment reduced to scrap. Presto is now in the process of modernizing its lines, however, most of its equipment is being overhauled, not scrapped.

Not only has Presto produced a lot of projectiles, but it has produced them on time. Once the lines were reactivated, Presto delivered projectiles on or ahead of schedule.

Presto shells are of the highest quality. The people who load, pack and assemble the shells ought to know quality better than anyone else. For years those pople have raved about Presto's phenomenally low defect rate and its ability to control projectile weight.

Government in-plant inspectors are also experts in the field of quality. The Government in-plant inspectors have shown their appreciation of Presto's quality by dramatically reducing their inspection team: from a high of 67 men in 1967 to 55 men in 1968, to 35 men in 1969, and finally to 14 men in 1971.

Presto managed to hold and even reduce (it usually reduced) its prices during the inflationary economy of the late 60's and early 70's. How did it do it? Mostly by being extraordinarily efficient, by using its work force more effectively, by producing less scrap, and by procuring material at bargain prices. Presto has a wonderful purchasing department filled with some very hard nosed bargainers. Those bargainers through negotiation persuaded the steel companies to furnish bar quality steel (steel held to a closer tolerance) at the price of shell section steel. The difference in price between bar quality and shell section steel ranged from a low of $14 per ton to $31 per ton. Since it takes about 17,000 tons of steel to produce 1,000,000 projectiles, you can see that is a lot of money. Those same bargainers also negotiated some very advantageous long term steel procurement contracts. Under one contract that began in 1968 and ran through December of 1971, Presto purchased steel at $142.50 per ton and watched the market price climb to $181.50 per ton. Steel was such a bargain at $142.50 that once Presto had bought enough steel to meet its own needs, it urged the Government to buy 50,000 tons of steel for the Government's use under Presto's steel contract.[3] Under another contract, Presto had the right to purchase steel at $195.50 per ton during a period in which the market price rose to $281.50 per ton.

By 1970, letters of congratulations and awards began to pour in. The Secretary of Defense and generals and other officials from the Office of the Assistant Secretary of Defense, the Office of the Assistant Secretary of the Army, the Army Material Command, Picatinny Arsenal, Frankford Arsenal, the U.S. Army Armament Command, the U.S. Army Ammunition Procurement and Supply Agency, and the Defense Contract Administration Services Offices in Chicago and Milwaukee all wrote to congratulate Presto on the quality, quantity and price of its projectiles. The President of Presto, a small, jolly man who looks like St. Nick, was elected to the U.S. Army Hall of Fame (one of the few civilians who had ever been so honored) and was awarded the Department of the Army's Outstanding Civilian Service Medal. Last but by no means least, Presto has received two letters of praise from the great cost cutter himself, Senator William Proxmire. The Senator congratulated Presto on its "cost saving efforts" and called it, "an efficient military contractor."

At this point, you must be waiting for those familiar words, "and Presto lived happily ever after." Prepare yourself for a shock. In 1971 the Renegotiation Board began its proceedings to renegotiate Presto's contracts with the Army. The Company was not worried—with its record there was nothing to worry about. It waited expectantly for a clearance and perhaps a few glowing words for its accomplishments. The clearance did not come. What did come, came on May 21, 1976—a whopping Renegotiation assessment for $25,300,000, 63 percent of the determinations the Board reported for the entire fiscal year ending June 30, 1976.

Like most tales, this tale has a moral:

"If you are a Government contractor, do not take risks and do not be efficient. You may earn profits by operating efficiently and by assuming risks. But you will not be able to keep such profits. The Renegotiation Board will take them away from you."

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[3] The Army negotiators who authorized purchase of the 50,000 tons of Government steel were each awarded the Presidential Management Improvement Award for achievements in reducing the Army's procurement costs.

Mr. TOLLEY. Let me take a couple of minutes now and talk about some of the points that Mr. Kaufman raised.

He talked at length about the administrative costs, that they could not be established by any auditing process. And he used the average amount of $20,000 that one study had revealed and that that could not be supported.

I would just say this from an experience point of view, from this company that it is very easy to expend $20,000 annually on a legal bill to get legal advice in dealing with something like a Renegotiation Act, which has its own regulations, its own procedures, that are outside the ordinary business activity.

In fact, it is another layer in the costs, the costs go beyond that. Public accounting costs each year would involve an exercise of trying to establish if excessive profits will be determined at some later date will be returned? I don't think we should be in the business here of worrying about how to keep that kind of activity and those people employed.

But $20,000 may well be the minimum level of the outside costs, just from the standpoint of dealing with the Board as it was constructed in the past.

Mr. Kaufman also said that the underlying reason for the Renegotiation Board was an independent—there was need for an independent agency to oversee the activity.

As my recollection from reading the history of the Vinson-Trammell Act and the Renegotiation Board is there was a serious concern by Congress over the execution of contracts in a wartime emergency condition—that there was not time to properly form contracts at the outset, thus some extraordinary procedure was necessary.

I would submit the Renegotiation Board was temporarily extended a number of times, it was a temporary agency, and that this underlying reason was not the original reason that that Board was formed.

Of course, as we know, there is legislation on the books now that would provide for the implementation of some extraordinary procedure in an emergency condition.

I would like to close by identifying what I believe is the real problem, and I think what we should be concerned with in this country today is the national competitiveness of our society. The problem is in growing proportions, and one of the underlying problems contributing to the U.S. global trade deficit.

This matter was covered in great depth by the President's Commission in International Competitiveness. The Commission focused on the definition of competitiveness and concluded on the following, "competitiveness is the degree to which a nation can under free and fair market conditions, produce goods and services that meet the test of international markets while simultaneously maintaining or expanding the real incomes of its citizens."

Included in the Commission's recommendations were the following, first, enhance incentives for private sector development. Second, make excellence in manufacturing technology an American advantage. Third, strengthen protection of intellectual property rights. And fourth, balance the goals of the legitimate goals of regulation with the need to bring the results of innovation to markets.

There is nothing related to profit limitations that will aid in meeting any of these objectives. In fact, I believe just the opposite is true. The President's Commission reached the conclusion that, and I quote, "Americans must take on the challenge of competitiveness as an economic agenda for the next decade."

We urge this subcommittee to assume that same conclusion and focus on Government policies that lead in that direction and reject policies that run counter to this goal.

Thank you.

[The prepared statement of Mr. Tolley follows:]

STATEMENT OF WILLIAM R. TOLLEY

BEFORE THE

SUBCOMMITTEE ON GENERAL OVERSIGHT AND INVESTIGATIONS

OF THE

HOUSE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE

OCTOBER 30, 1985

Mr. Chairman and members of the Committee, I am pleased to appear before you this morning and to comment on proposed legislation to resurrect the Renegotiation Board. My name is William R. Tolley. I am the Director of Legislative Affairs for Harris Corporation.

Harris Corporation is a producer of advanced information processing, communication and microelectronic products for the worldwide Information Technology market. The company's products, systems, networks and components - which are used to process and communicate data, voice, text and video information - are sold in more than 100 nations of the world. In fiscal 1985, Harris had sales of $2.3 billion, employed 31,000 people and operated 35 plants in the United States, Canada, Europe and Asia.

In previous capacities with Harris, I had responsibility for dealing with the Renegotiation Board as well as many other aspects of government contracting. Thus, I have a long standing interest in the matter before you today.

Mr. Chairman, as you know and many others on this committee know, the issue of the Renegotiation Board was debated at great lengths during the 94th, 95th and 96th Congresses. The result being that the Board was terminated in March 1979. Subsequent to the termination of the Renegotiation Board, Congress dealt with another profit restriction law, that being the Vinson-Trammell Act. Like the Renegotiation Board, the Congress terminated the Vinson-Trammell Act, an act affecting military aircraft and naval vessels that had lain dormant because of the existence of the Renegotiation Board.

There are many reasons that these two laws were rejected by Congress but I believe there was one overriding reason that both were turned down. That reason is simply that profit limitations do not work. In the past, proponents of profit limitations have raised numerous issues to justify the imposition of such limitations. Many of these reasons sound convincing, and play well in the media, however when examined in an objective light, they fail to demonstrate how profit limitations will solve the perceived problems. On the other hand, it is quite clear as to how profit limitations negatively impact the interests of the U. S. Government, U. S. business and taxpayers as a whole.

Profit limitations have a negative impact because; they are anti-competitive, they discourage cost reduction, they lower productivity, they cannot be universally defined, and they further burden the procurement process.

I believe it is important to share the same vantage point concerning government procurement. A great amount of the U. S. Congress' effort is directed at the regulation of our societal activity. The issue is different here, however, in that the government is attempting to acquire its needs rather than simply carrying out its governance role.

In other words, the government needs to create a fundamental business relationship with the supplier. The U. S. Government is the customer and the business entity is the provider of goods or services. What the U. S. Government should want is a product that performs and fulfills the need just as any customer expects. This distinction is important when considering legislation relating to or impacting the procurement system.

The supplier has the objective of fulfilling that need and making, at a minimum, the profits necessary to remain in business and to continue to perform. The

government's primary concern should be whether it is receiving the goods contracted for at a reasonable price. Inclusion of profit limitations in the contracts interrupts this basic business relation and leads to decreased efficiency, possibly even decreased quality and other performance parameters. Whether the contract is priced competitively or priced on a sole source basis, profit limitations tend to be counterproductive. In short, if the pot at the end of the contract rainbow is for the supplier to pay to the government the fruits of excellence, then mediocrity is rewarded and excellence is discouraged.

To further elaborate this point, I recommend for your reading a real life saga entitled, "A Grim Fairy Tale". This is a statement by the National Presto Industries, Inc. submitted to this committee in 1977.

The government as with any customer should harness the profit motive by forming contractual terms that incentivize and motivate the supplier to the most efficient, most productive and best performance under the contract. The U. S. Government, as with any other customer, should be worried about the propriety of the agreed upon price and not unduly concerned about the makeup of that price.

Existing Federal Government Policy faces this matter squarely and deals with it in a responsible manner. The policy can be found in the Federal Acquisition Regulations (FAR) and the Department of Defense Supplemental Regulations. FAR, Part 15.901, paragraph (b) states:

> "It is in the Government's interest to offer contractors opportunities for financial rewards sufficient to (1) stimulate efficient contract performance, (2) attract the best capabilities of qualified large and small business concerns to Government contracts, and (3) maintain a viable industrial base."

Further, Department of Defense FAR Supplement 15.901, (c) states:

> "Furthermore, low average profit rates on defense contracts overall are detrimental to the public interest. Effective national defense in a free enterprise economy requires that the best industrial capabilities be attracted to defense contracts. These capabilities will be driven away from the defense market if defense contracts are characterized by low profit opportunities. Consequently, negotiations aimed merely at reducing prices by reducing profits, with no realization of the function of profit, cannot be condoned. For each contract in which profit is negotiated as a separate element of the contract price, the aim of negotiation should be to employ the profit motive so as to impel effective contract performance by which overall

costs are economically controlled. To this end, the profit objective must be fitted to the circumstances of the particular acquisition, giving due weight to each of the effort, risk, facilities investment, and special factors set forth in this subpart. This will result in a wider range of profits which, in many cases, will be significantly higher than previous norms."

Let's briefly examine the procurement options open to the Department of Defense (DOD) for attaining the best product at the lowest price while adhering to the profit policy.

- Advertised procurements where there is more than one supplier capable of providing the required goods and services bidding for the work.

- Commercial catalog items available from suppliers at prices equivalent to those given their commercial customers including quantity discounts.

- Competitive negotiated procurements where there are several available suppliers who bid on the work but the final price is negotiated with the selected supplier.

All of the foregoing are considered competitive procurements and should not be considered candidates for "excessive" profits.

It is in the sole-source, non-competitive procurement environment that suggests the possibility of "excessive" profits. The types of contracts available to the DOD in non-competitive situations are flexibly priced contracts (such as fixed-price incentive, cost plus incentive fee and cost reimbursable plus fixed fee) or firm-fixed-priced contracts.

Flexibly priced contracts are subject to final price determination after contract completion and thus are subject to final contract settlement. The amount of costs incurred by the contractor in performance of these contracts affect the final price. In negotiating these contracts initially, the contractor must provide cost data to the DOD and certify that it is current, accurate and complete. In the event, after contract award, it is determined that the cost data used in setting the contract is defective by not being current, accurate or complete, the DOD can recoup the amount of the price affected by the defective cost data. Therefore, the government has great protection from "unjust enrichment" in flexibly priced contracts in the non-competitive as in the competitive environment.

Firm-fixed-priced contracts place the full risk of contract performance on the contractor—none on the DOD. If the contractor's costs increase, the business entity must bear the loss. In the event the contractor can lower costs, the business entity should be entitled the higher profits as a reward for efficient performance. Profit limitations are a one way street requiring the contractor to bear the loss generated by increased costs but inequitably return monies to the government for contractor efficiencies.

As we mentioned earlier in the statement, profit limitations cannot be universally defined. Let's examine the profit requirements of a capital intensive industry. The Department of Defense has established guidelines for determining profit negotiation objectives to be utilized by government negotiators. We recently prepared an analysis of the weighted guidelines calculation for a typical semiconductor production program utilizing the average financial characteristics of several semiconductor companies. This analysis reveals that an average of 20% profit on costs represents a normal midrange. Of course, rates higher or lower could also be appropriate in given circumstances. The industry is very cyclical in nature and at times may be operating at a loss or a break even due to volume considerations in the industry. Accordingly, when volumes are up, profit rates may be much higher than that which would be perceived to be nominal or average so that profit rates dramatically higher than 20% on costs at times should not be considered excessive. Profit rates necessary to a semiconductor company are significantly impacted by the high ratio of capital to sales required for that industry. If profit rates are not adequate or perceived to be inadequate, investment in those industrial sectors will not occur and they will atrophy into nonexistence.

This illustration should not be taken such that it suggests that we would endorse excessive profits, however the definition of and implementation of determination of what is excessive under particular circumstances has indeed been elusive. I suggest that there are no universal standards to determine what constitutes an excessive profit. Thus, excessive tends to be in the eye of the beholder. The perception is influenced dramatically by the model that one selects from which to measure performance. Quite typically, policy makers within the government, be they in the Executive branch or Congress, tend to utilize the high dollar value prime contracts as a model to determine the necessity of contractual controls, regulations, etc. However, this model has limited applications.

There is a vast difference in business parameters including profitability necessary under a prime major weapons system contract and a subcontract for component parts; particularly if those component parts are produced within a capital intensive environment. While in certain instances some particular special regulatory procedure may be in order, that procedure may be totally

inappropriate if applied to all contractual situations. Let me give you an example. Under the previous Renegotiation Act and Board's activities, competitively awarded contracts were included in the Renegotiation Board's jurisdiction. As a concept, I suggest that that is wrong. I believe that it should be axiomatic that excess profits do not exist in a competitive situation.

I submit that the real problem we should be concerned with here today is national competitiveness. This problem is of growing proportions and is one of the underlying problems contributing to the United States' global trade deficit. This matter was covered in great depth by the President's Commission on Industrial Competitiveness. The Commission focused on the definition of competitiveness and concluded on the following:

> "COMPETITIVENESS IS THE DEGREE TO WHICH A NATION CAN, UNDER FREE AND FAIR MARKET CONDITIONS, PRODUCE GOODS AND SERVICES THAT MEET THE TEST OF INTERNATIONAL MARKETS WHILE SIMULTANEOUSLY MAINTAINING OR EXPANDING THE REAL INCOMES OF ITS CITIZENS."

The Commission made certain recommendations to increase U. S. competitiveness. Included in these recommendations were the following:

- Enhance incentives for private sector research and development.
- Make excellence in manufacturing technology an American advantage.
- Strengthen the protection of intellectual property rights.
- Balance the legitimate goals of regulation with the need to bring the results of innovation to market.

There is nothing related to profit limitations that will aid in meeting any of these objectives. In fact, just the opposite is true. The President's Commission reached the conclusion that:

> "AMERICANS MUST TAKE ON THE CHALLENGE OF COMPETITIVENESS AS THE ECONOMIC AGENDA FOR THE NEXT DECADE."

We urge this Committee to assume that same conclusion and focus on government policies that lead in that direction and reject policies that run counter to this goal.

Chairman HUBBARD. Thank you, Bill Tolley, for your excellent presentation. We will ask questions after we have heard from Mr. Mulligan and Mr. Grenough. First, Mr. Mulligan.

STATEMENT OF RICHARD G. MULLIGAN, CHAIRMAN, COMMITTEE ON GOVERNMENT BUSINESS, FINANCIAL EXECUTIVES INSTITUTE

Mr. MULLIGAN. Thank you, Mr. Chairman.

I am appearing as the chairman of the committee on government business for the Financial Executives Institute. But I am also vice president of Financial Control for TRW and we are headquartered in Redondo Beach, CA, which is a little further from here than Florida.

Chairman HUBBARD. I appreciate your being here. I knew you were with Bruce Benefield of TRW here in Washington.

Mr. MULLIGAN. Right.

As you know, we testified on this subject many times in the past. What I would like to do is similar to Bill Tolley; just dispense with most of my prepared remarks since they are in the record and just cover a few highlights and then get back to some of the items discussed this morning.

On renegotiation in general, we believe it is bad public policy because the threat of renegotiation takes away from contractors the incentive to become more efficient producers. Also I can think of no other industry in the private sector who after entering into a contractual agreement in good faith, is subjected to a postreview and recoupment of profit years after the contract is completed.

Renegotiation doesn't happen elsewhere for several reasons. First, it is a practice that is considered unfair and inappropriate by most standards. Second, renegotiation fails to promote economic efficiency and productivity.

These were the very same points along with many others that we raised in 1976 when Congress decided to eliminate the Renegotiation Board.

The proposal is an apparent reaction to an erroneous perception that "war profiteering" is rampant. There is no objective evidence to support such a claim. Other than on an emotional basis, no one knows what "war profiteering" or "excessive profits" means. I will discuss this later.

There seems to be a lot of confusion on excess profits and what they might be. These terms are not definable in absolute or objective terms.

It would seem that before any legislation is enacted, we should be certain that a problem exists. I am well aware of the many spare parts horror stories of $400 hammers, $7,000 coffeepots and $600 ashtrays that may have created an impression that defense contractors are making excess profits. They play well in Peoria through the media but there is a rational explanation for each of them. Let me simply mention that out-of-production spare part replacements constitute less than 1 percent of the DOD procurement budget and do not reflect the overall situation.

We have had four or five profit studies, the latest being DFAIR and they all seem to show, as this latest one has shown that profits in the defense industry are adequate and an equitable return is being made by defense contractors.

We believe there is no real need for legislation. If someone were to believe you needed legislation, this particular legislation is defective for a number of reasons.

First, it is fundamentally "unfair." Other regulated industries are usually assured an adequate profit; none is provided here. I am not proposing that you guarantee a profit, but at least the "heads I win, tails you lose" provisions of the bill in not permitting losses to offset profits are inherently inequitable. Even the Internal Revenue Service recognizes the inherent fairness of the offset.

Second, this bill focuses attention on the wrong problem. With the focus of the proposed legislation on contractor profits rather than on final cost to the Government, renegotiation is counterproductive to the desired goal of reducing total costs.

The Congressman earlier talked about brassieres and I will go a little closer to the ground and talk about boots. Should, for example, a procurement officer buy $70 a pair boots because the price includes a modest 10-percent profit? Or, should he buy the same boots for $50 which includes a 30-percent profit? Is the profit excessive but the price right? What should be his focus—profit or total cost? Isn't it more important to incentivize industry to reduce the total cost of the procurement to the Government?

Third, a bill such as the one before you could create an attitude in procurement of "who cares." That is, the individual procurement officer would make any deal he can make easily. After all, if he awarded a contract with too much profit, any mistakes will be recovered by renegotiation.

Fourth, the bill which calls for product line renegotiation is totally inequitable, impractical, and nonproductive. It is inequitable, because it singles out an individual portion of a contractor's output for artificial measurement. It is impractical, in that, depending on the relationships of all products produced by a contractor, it forces unnatural segregation of costs, and unrealistic allocation of profits to achieve a desired result.

It is nonproductive in that it requires the creation of a data bank of significant magnitude that makes no contribution to the productivity of the contractor. Rather, it would increase costs and offset attempts to enhance both output and efficiency. Further complicating this issue is the fact that contractor product lines are organized to suit each company's environment rather than according to a uniform set of guidelines.

Our conclusions are: The previous legislative actions now augmented by additional legislation provide more than adequate justification for Congress to reaffirm their decision not to fund the Board.

There is no credible case that excess profits problems exist.

Product line negotiation is inequitable and nonproductive.

Profit recoupment will destroy the motivation of the Government to achieve optimal negotiated price.

Profit recoupment will impede capital asset growth by lowering the amounts available for investment in productivity enhancing capital equipment.

Profit recoupment reduces the incentive of a producer to lower costs by innovative and efficient performance since the profits earned by such innovation make him a target for renegotiation.

The total cost to the Government issue is overridden by the attention focused on profits.

Existing legislation and DOD procurement process adequately protect the taxpayer.

The cost of recoupment legislation would probably cost the taxpayer more than it would recoup.

Now a couple of other items that were mentioned this morning. If I may comment on Truth in Negotiation Act, which was discussed at great length.

The 87th Congress, as we know, passed that act but over the years, and I have lived with this act for a number of years, it is a great protection for the taxpayer. During the last few years, it has received even more highlight than it has ever had before. In the past, if a contractor were guilty of not supplying current, accurate, and complete data, after audit, he would have to make a reduction in price which in essence would be refunding excess profit.

The adjustment in the price of the contract was made.

Many contractors did that over a period of time.

Today we have an entirely different environment. Today what you have is the contractor if he is guilty of defective pricing he is also a candidate for de facto fraud. If you look at the list of the items cited when they said 45 contractors were under criminal investigation, most of those were defective pricing cases and up to now, we didn't think that defective pricing was a crminal case but apparently it is.

Lawyers, seminars, lectures, training, there is quite a bit going on in the Government procurement community on the contractor side to be sure that everybody knows how truth in negotiation works.

The DFAIR study was mentioned quite a bit. The GAO certainly is on record saying that they don't agree with the methods of how it was done, and so on. Mr. Kaufman was confused by some terminology.

The GAO testified that one of the concerns about the validity of the study is it is based on unaudited data voluntarily submitted by defense contractors. Now, the defense contractors volunteered; it is true. But it is my understanding that the contractors that did respond covered over 90 percent of the defense procurements in the periods that were involved. So, whether it was mandatory or voluntary, the information collected was a major portion of the defense procurement bill.

Now, as far as auditing is concerned, when Profit '76 was done, we submitted the data and our auditors looked at it and made a verification that later the GAO determined was inadequate. So when this profit study was initiated, a very elaborate system was devised to be sure that the contractor's independent auditors verified the data.

Now, in our particular case, this was quite an extensive audit and tied into the books of account. It cost over $70,000 to us to pay our outside CPA firm, Ernst & Whinney, to audit this data; and the other contractors had similar bills.

Something is radically wrong if this type of audit cannot be accepted. It seems as though the GAO is saying that unless they look at the numbers and unless they personally audit them, the numbers are not correct.

This is just wrong, Mr. Chairman. Those numbers can be relied on.

I make no statement about whether DFAIR is a good report or not. I am saying that the methodology was correct, and I think that the record should be straight from the standpoint of a contractor saying that it was audited, the data was audited, and not have the record state that it was voluntary data and, therefore, we need this tremendous Board to go get the data on another basis.

So, I think the DFAIR story will be dealt with by later hearings. But at least for this part of it, I can tell you definitely the data was audited.

The other thing bothering Mr. Kaufman was the term "markup." He said they seem to have gone to nefarious new words; they are using "markup" instead of "profit." The problem had been in the past that when the only records that were available on defense profits were the negotiated or going-in profits, and every time those were reported as increasing, the press would pick it up and say defense contractor profits are increasing.

This was the amount that was negotiated on the cost before you went into the contract. It had no relationship at all to the realized profit when the contract had been completed. So, in the interest of trying to get proper terminology, the "markup" term was used for the going-in profit.

The realized profit is what you end up with when the contract is completed.

Where did the term come from? Webster's Dictionary says it is an amount added to the cost to produce a selling price.

In the Government business, that is exactly what we do. We don't make any profit when we add that amount on. We don't make any profit until the contract has been completed.

Now, there was quite a bit of talk about excessive profits and how you define them, and some testimony with respect to the costs of running the Board. I had to defend our RB–1 forms when the Renegotiation Board was in existence. One of the problems was, Mr. Chairman, that the Board looked at the business on a year-by-year basis, and we had particular situations—even though we were not reporting by contract, we reported by type of contract. And if the profit on the type of contract appeared excessive, they would want to know what detail contracts this occurred on.

In our case, we had situations where we have built satellites which would be in orbit, and the orbital performance was earning profit. At the same time, there wasn't much cost in a given year; but when they snapshot the one year, the profit would appear, quote, "excessive," and they wanted a refund.

And I would say, no way; look at the total contract. The total contract is producing the profit at 6 percent. They said, oh, no; this one year we are looking at a profit of 35 percent, and that is excessive. We want a refund. What is the cost of renegotiation? Arguing things like that, and litigating them, et cetera, is expensive.

So what is excessive? It is a difficult thing to have a board look at and say in a given year this profit is excessive.

I have other comments, but in the interest of time I think we ought to pass to Mr. Grenough.

[The prepared statement of Mr. Mulligan follows:]

STATEMENT OF RICHARD G. MULLIGAN, ON BEHALF OF THE FINANCIAL EXECUTIVES INSTITUTE, COMMITTEE ON GOVERNMENT BUSINESS

Good morning. Mr. Chairman, I am Richard G. Mulligan, Vice President, Financial Control, of TRW Inc. I am appearing here today as Chairman of the Committee on Government Business of the Financial Executives Institute.

The Financial Executives Institute (FEI) is a professional organization of over 12,500 individual members who are senior financial and administrative officers of over 6,000 companies that represent virtually all segments of the economy. It is this professional background and experience that qualifies us to address this topic. The Committee on Government Business is authorized to form, on behalf of the FEI, statements or positions relative to existing or proposed federal legislation and regulations designed to mandate: 1) accounting principles, standards or practices; 2) recordkeeping and reporting; and 3) other financial-related rules to be followed by private business enterprises providing goods and services directly or indirectly to the federal government.

As you know, the FEI has testified many times in the past against profit limiting legislation, and we appreciate the opportunity to testify again today.

I know that you have convened this hearing to discuss specifically H.R. 3020, the "War Profiteering Prohibition Act of 1985." However, I feel compelled to begin my statement by expressing my concerns about renegotiation in general. Simply put, Mr. Chairman, renegotiation is just bad public policy.

It's bad public policy because the threat of renegotiation takes away from contractors the incentive to become more efficient producers. Also, I can think of no other industry in the private sector who, after entering into a contractual agreement in good faith, is subjected to a post review and recoupment of profit years after a contract is completed. Renegotiation doesn't happen elsewhere, for several reasons. First, it is a practice that is considered unfair and inappropriate by most standards; second, renegotiation fails to promote economic efficiency and productivity. These are the very same points, along with others, that we raised in 1976 when Congress decided to eliminate the Renegotiation Board.

This proposal is an apparent reaction to an erroneous perception that "war profiteering" is rampant. There is no objective evidence to support such a claim. Other than on an emotional basis, no one knows what "war profiteering" or "excessive profits" means. These terms are not definable in absolute or objective terms.

It would seem that before any legislation is enacted, we should be certain that a problem exists. I am well aware of the many spare parts horror stories of $400 hammers, $7000 coffee pots and $600 ash trays that may have created an **impression** that defense contractors are making excess profits. Without going into the details (and there is a rational explanation for each of them) let me simply mention that out-of-production spare part replacements constitute less than 1% of the DoD procurement budget and do not reflect the overall situation.

In support of this, the four major studies that have been made of profits on defense contracts (two by the Logistics Management Institute, one by the GAO, and one by the DoD) covering the years 1958 through 1974, show that profits by defense industries on government contracts are essentially in line with profits for similar work.

In 1983, the Defense Financial and Investment Review (DFAIR) was established to review the period from 1975 through 1983. In general, the DFAIR analysis concluded " that current contract pricing, financing, and markup policies are balanced economically, are protecting the interests of the taxpayer, and are enabling U.S. industry to achieve an equitable return for its involvement in defense business..."

We believe that there is no real need for this legislation. However, even if there were a need, *this* legislation is defective, for a number of reasons.

First, it is fundamentally "unfair." Other regulated industries are usually assured an *adequate profit*; none is provided here. I'm not proposing that you guarantee a profit, but at least the "Heads I win, tails you lose" provisions of the bill in not permitting losses to offset profits are inherently inequitable. Even the Internal Revenue Service recognizes the inherent fairness of the offset.

Secondly, this bill focuses attention on the *wrong* problem. With the focus of the proposed legislation on contractor profits rather than on final cost to the government, renegotiation is counterproductive to the desired goal of reducing total costs.

Should, for example, a procurement officer buy $70-a-pair boots because the price includes a modest 10% profit? Or, should he buy the same boots for $50 which includes a 30% profit? Is the profit excessive but the price right? What should be his focus--profit or total cost? Isn't it more important to incentivize industry to reduce the *total cost* to the government?

Isn't it also true that the profit motive is necessary to stimulate the investment in new capital equipment to increase productivity in order to reduce **total cost**?

Third, a bill such as the one before you could create an attitude in procurement of "who cares!" That is, the individual procurement officer could make any **deal** he can make easily ... after all ... any mistakes will be recovered by renegotiation.

Fourth, the bill which calls for **product line** renegotiation is totally inequitable, impractical, and nonproductive. It is inequitable, because it singles out an individual portion of a contractors output for artificial measurement. It is impractical, in that, depending on the relationships of all products produced by a contractor, it forces unnatural segregation of costs, and unrealistic allocation of profits to achieve a desired result. It is nonproductive in that it requires the creation of a data bank of significant magnitude that makes no contribution to the productivity of the contractor. Rather, it would increase costs and offset attempts to enhance both output and efficiency. Further complicating this issue is the fact that contractor product lines are organized to suit each company's environment rather than according to a uniform set of guidelines.

Consider also that in 1979, when Congress terminated the Renegotiation Board, one of the considerations was the adequacy of the existing laws and regulations to protect the interest of the taxpayers.

o Truth in Negotiation Act (Public Law 87-653) requires certification of actual cost and pricing data used by the contractor. It also provides for audits and recoveries by the government.

- Cost Accounting Standards Act (Public Law 91-379) has now established 19 cost accounting standards that assure uniformity and consistency in government contract cost accounting and penalties are provided for failure to comply.
- Anti-Kickback Act, amended in 1981, prohibits gifts from subcontractors to primes as an inducement for the award of a subcontract.
- DoD Inspector General (IG). The modification of the 1978 Inspector General Act in 1982 created the DoD IG. This has imposed an additional level of investigative review and authority to assure compliance with regulatory and statutory requirements.
- Gratuities 10 USC 2207 prohibits the giving of gratuities.
- Fraud Statutes and the enforcement actions related to fraud by the Inspector General and the Department of Justice provide additional impact to all of these statutes.
- Cost Allowability Rules Section 15 of the Defense Acquisition Regulations (DAR) defines specific allowable and unallowable costs and requires specific allocations. Major disallowances are interest, advertising, contributions, overceiling research and development expenditures. All reduce profit considerably. None of these have been repealed and all are working as effectively as they did in the past. In addition, Congress has enacted significant legislation that further reduces the potential for excessive profit.
- Provisions in the 1986 DoD Authorization Act specifically require 10 cost items to be expressly unallowable and 14 additional cost items to be more clearly defined to eliminate ambiguities. The bill further provides for:

- DOD initiatives including overhead should-cost negotiations. Deputy Secretary of Defense Taft's overhead initiatives require a review of cost allowability regulations for clarity and changes to cost principles that will reduce cost recovery.
- The Act contains a requirement for contractors to certify overhead submittals on DOD contracts
- More authority is given to the Defense Contract Audit Agency (DCAA). These include a requirement for audit resolution if the contracting officer does not agree with the DCAA recommendations, a requirement for DCAA audits of subcontractor cost proposals, increased access to contractor records through the use of the subpoena power, and the directive to give DCAA the authority to determine contractor overhead rates.
- The FY'86 DOD Authorization Act also contains provisions to shift to industry the burden of proof regarding the reasonableness of disputed costs. Another provision requires the disclosure of extensive labor cost data comparing industrial engineering standards to actual performance. Penalties for false claims was increased from $10,000 to $1,000,000 and the imposition of interest penalties for overpayment of overhead cost are also included in the Act.

The Administration has also taken additional actions to safeguard against abuses and the horror case examples concerning spare parts. A number of steps have been taken in the past two years by the DoD and contractors to improve the spare parts acquisition process:

- On July 25, 1983, the DoD issued a "ten-point program" on spare parts procurement to the Services. The program provided for incentives and disciplinary actions to encourage DoD employees to buy spares smartly and challenge unrealistic prices and price increases. It also required acceleration of reform on contracting procedures, obtaining refunds for overcharging, development of alternative sources, and further audits and investigations.

- On February 24, 1984, the DoD issued a memorandum to the Services requiring contractors to identify parts they did not manufacture, and requiring the allocation of general and administrative expenses to spare parts be related to their value.
- Defense contractors have individually introduced initiatives to improve the spares acquisition process. Several contractors provide money-back guarantees where the government may return an item for a full refund if it determines it was overpriced. Most contractors direct government customers to other sources for spares if they feel they cannot provide the part at a price that reasonably reflects the part's intrinsic value. Contractors also discourage the procurement of inefficient quantities of spares by identifying the cost-effectiveness of volume purchases to their government customers.

In addition to the actions outlined above, there have been numerous directives, memoranda, and other forms of guidance issued by OSD, the Services, and their subelements addressing more specific issues. The spare parts acquisition process is receiving high-level management attention on a continuing basis by DoD and industry.

Mr. Chairman, we believe that it would be wise for this Subcommittee to review the past history of the Renegotiation Board and determine once and for all whether or not you believe the Board was ever successful in achieving its stated mission. I believe that you will find, as did we and a majority in Congress, that the Board was a failure. One reason for that failure was the mistaken belief by some that the concept of profit recoupment actually saves taxpayers money. That is a myth. Past studies have verified that total costs of administering the recoupment process have exceeded any amounts actually recouped. This myth also doesn't consider the long term, insidious, deleterious effect recoupment has on the costs of products purchased by the government because it institutes in perpetuity a level of administrative costs greater than value of the potential recovery.

The concept that profit recoupment is good "public policy" is not true. Regardless of how profit recoupment policy is created, in reality the policy is nothing more than a downward-only, unilateral contract price adjustment. This practice is inherently inequitable, punitive, and a tremendous disincentive to producers. It is also the opposite of action needed to encourage producer efficiency, innovation and competition. It contributes to the worsening problem of overregulation.

In summary, our conclusions are as follows:

We believe that the previous legislative actions, now augmented by additional legislative and administrative safeguards, provide more than adequate justification for Congress to reaffirm their decision not to fund the Renegotiation Board.

- o There is no credible case that an excess profits problem exists.
- o Product line renegotiation is totally inequitable, impractical and nonproductive.
- o Profit recoupment will destroy the motivation of the government to achieve the optimal negotiated price.

- Profit recoupment will impede capital asset growth by lowering the amounts available for investment in productivity enhancing capital equipment.
- Profit recoupment reduces the incentive of a producer to lower costs by innovative and efficient performance, since the profits earned by such innovation make him a target for renegotiation.
- The total cost to the government issue is overridden by the attention focused on profit.
- Existing legislation and the DoD procurement process adequately protect the taxpayer.
- The cost of profit recoupment legislation will probably cost the taxpayer more than it would recoup.

Thank you, Mr. Chairman, for this opportunity to express FEI's views on this subject. I'd be happy to answer any questions that you might have.

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Chairman HUBBARD. Thank you very much, Mr. Mulligan.

Now we will call on Don Grenough.

STATEMENT OF DONALD S. GRENOUGH, PARTNER, TOUCHE ROSS & CO.

Mr. GRENOUGH. Thank you, Mr. Chairman and members of the committee. I do appreciate the opportunity very much to appear before you today.

I will give a relatively brief condensation of the statement we have submitted that is more expansive.

I am a partner in Touche Ross, an international public accounting firm, and I am director of government contracting services for our firm. My work experience includes various phases of Government contracting in industry, in Government, and in public accounting.

I come to you today to share my experiences and thoughts on the proposed renegotiation legislation, in the hope that you will recognize, as I do, that the legislation is not necessary and would, in my opinion, be very counterproductive.

I will say little about the significant improvements in defense procurement that I have observed, dating back to 1951. The record of hearings on prior proposed legislation, subsequent to the demise of the Renegotiation Board in 1979, is filled with such data. During the seventies and eighties, we have witnessed, I believe, a barrage of legislative and regulatory changes, much of which have been addressed here this morning and this afternoon, which address the procurement process.

Without questioning the wisdom of each of these changes, most of which I believe are appropriate, it is well for the Congress to focus on these changes in relation to the existing proposed legislation. By considering these changes, the Congress should be able to see their cumulative positive impact in the defense contractor community, with particular reference to the beneficial impact on contract pricing.

I would now like to turn to the specific language of the bill which states, "The Board shall renegotiate all contracts and subcontracts by division and by major product line within a division of the contractor or subcontractor." I believe there is a strong case to be made against this.

The notion of product line renegotiation results from a perceived weakness in the 1951 Renegotiation Act whereby large companies involved in multiple product lines were able to offset high profits in some product lines against low or so-called deficient profits in other product lines, the net effect being on the company as a whole there were no excessive profit determinations.

I would like to focus your attention on some negative aspects of product line renegotiation that previous testimony, I believe, on similar legislative proposals, really has not completely addressed. I believe that the proponents of product line renegotiation have advocated this method for one reason only—primarily because it will produce higher determinations of excessive profits in contrast to renegotiation conducted at the total company level.

However, this reason alone is far from a valid basis for legislation since, to me, it lacks any real logic or conceptual soundness. If the purpose of legislation is simply to collect money from contractors, renegotiation can be conducted at lower levels of contractor operations then product line, and this will result in the Government collecting even more money than under product line renegotiation.

Take an extreme example: Why not conduct renegotiation at the level of individual cost element within the contract and not permit offset of cost overruns and cost underruns. Assume, for example, that labor costs on a contract is estimated at $20 million, but actual labor costs amount to only $11 million, which gives rise to a potential $9 million excess profit determination. The application of the statutory factors in the act may give the contractor considerations for such things as efficiency, technological breakthroughs, and thereby decrease the actual excessive profits only to $5 million for the element of labor cost.

At the same time, the contractor may have quoted $20 million for material costs and incurred actual costs of $25 million, or a $5 million cost overrun. Of course, this material cost overrun would be ignored and not offset against the labor cost underrun, since renegotiation in this example is conducted at the level of individual cost elements within a contract.

Most would say this is a rather ridiculous way to conduct renegotiation, and I would certainly agree. However, I would say that it is conceptually comparable, in my opinion, to the proposal that calls for product line renegotiation.

I think the inappropriateness of product line renegotiation comes into sharper focus when it is understood how companies view the Government marketplace in making pricing decisions and the effect of such decisions on the prices paid by the Government. Companies view the Government marketplace in its totality, its total effect on the entire corporate entity, including affiliated companies, and not on a contract-by-contract basis, not on the basis of individual line items of cost within a contract, not on a product line basis, and not even on a divisional basis. It is a total corporate approach.

This corporate marketing viewpoint has a direct effect on the pricing of individual contracts, including the individual elements of cost within a contract. For example, in pricing a highly competitive fixed price or incentive contract, the contractor may well forecast cost and profit that might be lower than permitted under the Government regulations, in order to arrive at a more competitive price. Under these circumstances, the Government benefits from a lower price. In addition, the contractor runs the risk of overrunning the lower cost estimates, thereby further reducing the low profit margins already included in the cost proposal.

Why is the contractor willing to take such a risk? In my experience, it is because that particular contract at that time fits into the total corporate objective, which could include a whole host of complex financial and marketing considerations, such as acquiring state of the art technology, retention of valued employees, sharing of common expenses, improved marketing position on identical or related products, or wanting to enter a new market.

Regardless of these corporate reasons, I suggest that Congress be aware of the fact that on price-competitive procurements, regardless of whether contracts are fixed price, incentive, or cost-type, contractors may propose costs that are less than could be justified under procurement regulations.

There is nothing improper or illegal in doing so, and the Government benefits from the lower contract prices that result from such pricing actions.

On the other hand, corporate entities ordinarily look for balance in the degree of profitability of its products or services so as to accomplish its present and future financial objectives.

Balance and profitability is achieved in a number of ways. For example, underrunning cost estimates through cost efficiencies will increase profits. In addition, maximizing contract prices on those products or services that are not subject to intense competition will achieve balance in corporate profitability.

In negotiated Government contracts, prices are legitimately maximized by including in cost proposals for any type of contract the maximum amount of cost and profit that can be justified under the Government regulations. The process of negotiating contract prices, including audit by DCAA of proposed costs and review of historical cost data along with the other multitude of advisory services to the contracting officer, ordinarily permit the negotiation of prices that are deemed reasonable by both contracting parties.

It should also, I think by the Congress, be recognized that product line renegotiation will not help cure other types of deficiencies in contract pricing, such as mischarging in Government contracts, defective pricing by the contractor, or spare parts overpricing. All of these problems are addressed aggressively by the Government in other legislative or regulatory actions.

Nor will product line renegotiation recapture excessive profits resulting from poor contract negotiation by Government personnel. With the increased professionalism in procurement personnel, Government has considerably improved, I believe, its contract pricing capability.

There are other very significant problems, I believe, in obtaining agreement on a definition of product line. Companies, in my experience, will define and report financial data for internal purposes on product lines in quite different fashions. Some companies will define product lines quite broad, while others have very narrow definitions.

Neither in external financial reporting nor regulatory compliance reporting is there a commonly accepted definition of product line financial reporting. Therefore, product line would have to be defined by statute or in the regulations in a way that would be equitable for all contractors. The FTC attempted to do this for several years some time ago in its line of business reporting, and was relatively unsuccessful.

Regardless of what definition of product line was finally adopted, it would undoubtedly require significant changes in contractors' internal recordkeeping because of the present diversity that exists among contractors in their financial recordkeeping.

Renegotiation by product line as proposed in the legislation within a division also penalizes some companies because it fails to recognize that some companies use two or more divisions to perform work on a single product line, rather than performing all the work in a single division. Under these circumstances, when two divisions perform work, division A may have high profits deemed possibly excessive, and division B may have low profits for the same product line. But low profits in B would not be offset against high profits in A.

On the other hand, take a competing company who might perform all of the work on the product line in the single division, in which case high and low profits from various parts of the work would be offset, resulting in no excessive profit determination.

The existing language in the act, therefore, I believe, may cause companies to restructure divisional organizations or place Government work in certain divisions only rather than performing the work in the organizational or functional location, which results in the most cost-efficient performance. Either of these occurrences, I believe, would cause Government contract prices to increase.

Singling out the product line level for renegotiation, in my opinion, is an artificial concept that fails to pass the test of reasonableness from either the contractor or Government viewpoint. Were product line renegotiation to become a reality, I believe, companies would alter their perspective of the Government marketplace by making uneconomic decisions that would damage eventually both the contractor and the Government.

For example, I believe companies may tend to quote higher prices on high-risk contracts or maybe not quote at all, because of the inability to offset low profits or losses against high profit contracts in different product lines. Developmental programs would be the first to suffer because these are generally viewed as high risk involving several years of losses or marginal profits before the contracts become profitable.

Another example would be, I believe, that companies would devote more resources to the commercial marketplace rather than the Government marketplace. This would be especially true in subcontractors performing less Government work than commercial work, thereby further debilitating our industrial subcontractor base.

Another example would be, I believe, that low profit product lines may be completely abandoned by contractors leaving the Government with fewer sources of supply. The management incentives to remain in certain product lines are varied and complex. Management may choose to remain in a low profit product line because it tends to complement a high profit line in relation to marketing objectives.

For example, it may provide balance in product lines available in the marketplace; it may permit the sharing of common expenses, facilities of production, or provide work for the factory to attain higher levels of plant utilization. However, these motivations may not be sufficient to continue in low profit product lines if the financial results are not permitted to be offset against high profit product lines.

In addition, I believe that faced with the recapture of excessive profits on a single product line, companies will lose incentives to maximize profits and tend to incur costs unnecessarily. This issue has been dealt with earlier this afternoon.

The resulting lower profits will cause less capital to be available to improve operations, including lower investments in cost saving fixed asset improvement, and this can cause price increases in product lines sold to the Government.

My final point. I would like to say that the fiscal year renegotiation concept directly conflicts, in my opinion, with product line renegotiation. Fiscal year renegotiation is similar to a snapshot in the life cycle of a product and can improperly result in excessive profit determinations in a single year.

Ordinarily, a product will be sold to the Government for several years. In the early years, sales and profits might well be lower than in the later years when costs per unit tend to be less and a higher profit is earned as the product matures.

For example, in a multiyear procurement, the same per unit price may be established for several years of production, even though the amount of costs and sales will vary considerably by years, causing different amounts of profit to be earned each year. Certain years in the life cycle of a product, usually the later years, will result in higher profits that may be deemed excessive, even though over the life of the product profits are quite normal.

Product line renegotiation on a fiscal year basis negatively focuses on this issue, and yields inequitable results by recapturing profits in certain years and ignoring completely low profits or losses in other years.

With Government spending billions of dollars for defense, there are always going to be some contractors, however few, guilty of wrongdoing such as overcharging, mischarging contract costs, defective pricing and fraud.

In considering the need for renegotiation legislation, the Congress should focus on whether or not there are any real excessive profits being earned by companies as a whole, the extent of such abuse, the existing laws and regulations aimed at such abuses, and the ultimate cost to the taxpayer of collecting such excessive profits from contractors, including the cost to contractors and Government of complying with the legislation.

An honest evaluation of these issues would, I believe, result in the decision that new renegotiation legislation is not warranted at the present time.

Thank you very much.

[The prepared statement of Mr. Grenough follows:]

Statement of
Donald S. Grenough, Partner
Touche Ross

Before the
Subcommittee on General Oversight and
Investigations of the House Banking Committee

On
H.R. 3020, The War Profiteering Prohibition
Act of 1985

October 30, 1985 - 10 AM

Mr. Chairman and Members of the Subcommittee:

I am a partner in Touche Ross, an international public accounting firm, and Director of Government Contracting Services for our firm. My work experience includes various phases of government contracting in industry, government & public accounting.

I come to you today to share my experiences and thoughts on the proposed renegotiation legislation, in the hope that you will recognize, as I do, that the legislation is not necessary and would be very counter-productive.

I will say little about the significant improvements in defense procurement that I have observed dating back to 1951. The record of hearings on prior proposed legislation, subsequent to the demise of the Renegotiation Board in 1979, is filled with such data. During the 70's and 80's we have witnessed a barrage of legislative and regulatory changes which address the procurement process. Without questioning the wisdom of each of these changes, most of which I believe are appropriate, it is well for the Congress to focus on these changes in relation to the existing proposed legislation. By considering these changes, the Congress should be able to see their cumulative positive impact in the defense contractor community, with particular reference to the beneficial impact on contract pricing.

The Case Against Product Line Renegotiation

Since the proposed legislation is intended to recover "excessive profits" and the title of the bill is the "War Profiteering Prohibition Act of 1985," it is well to define some critical terms.

"Excessive" is defined as "being too much or to great; immoderate; inordinate." "Profiteer" is defined as "a person who makes excessive profits, especially by taking advantage of a shortage of supply to charge exorbitant prices." Both of these terms as applied to government contractors carry very negative connotations, such as greedy, bad, an evil practice, unAmerican, a ripoff of the taxpayer, etc.

I would now like to turn to the specific language of the bill which states "The Board shall renegotiate all contracts and subcontracts by division and by major product line within a division of the contractor or subcontractor."

The notion of product line renegotiation evolves from a perceived weakness in the 1951 Renegotiation Act, whereby large companies involved in multiple product lines were able to offset high profits in some product lines against low or "deficient" profits in other product lines; so that the net effect on the company as a whole is no excessive profits. This perceived weakness in the 1951 Act must mean that advocates of product line negotiation view high profits in one product line as "unAmerican and a ripoff to the taxpayers," and must be recovered by the government.

Goodwin Chase, the last Chairman of the Renegotiation Board, frequently said that "the term deficient profits is not in my lexicon." Mr. Chase, of course, was an advocate of renegotiation by product line, even though the 1951 Act, under which Mr. Chase was operating, called for renegotiation of total company renegotiable sales, not product line sales. Were Mr. Chase here today testifying before the Committee I'm sure he would be a very avid proponent of product line renegotiation, as a source of untold millions of dollars of excessive profits which should recovered by the government. However, he is not testifying, and I have quite a contrary view point on product line renegotiation.

I would like to focus your attention on some negative aspects of product line renegotiation that previous testimony on similar legislative proposals has not completely addressed. I believe that the proponents of product line renegotiation have advocated this method primarily because it will produce higher determination of excessive profit than renegotiation conducted at the total company level. However this reason alone is not a valid basis for legislation. On the other hand if the purpose of the legislation is simply to collect money from contractors, in order to show taxpayers that Congress is protecting their interests, renegotiation can be conducted at other levels of contractor operations that result in the government collecting even more money than under product line renegotiation.

If renegotiation were conducted at any level below the total company level, the amount of excessive profit determinations would certainly be greater than prior determinations of the Board. There are a multitude of levels of company operation where renegotiation could be conducted. The amount of excessive profits will increase at each lower level of company operations where renegotiation is conducted. Levels below major product line will yield significantly greater excessive profit determinations. I suppose this means that the extent to which the taxpayer is being ripped off is dependent on the level at which renegotiation is conducted. I'm not sure the average taxpayer would understand this logic.

The 1951 Act permits consolidation of affiliated companies, therefore, this is the highest organizational level of renegotiation that would seem possible. Below this level, there are innumerable points where renegotiation is possible. The list below includes a number of the different levels, proceeding from the highest to the lowest level:

1951 Act - Consolidation of Affiliate Companies
    Single Company, Exclusive of Affiliates
    Division/Segment of a Company
    Major Product Line within a Company
    Minor Product Line within a Company
Proposed HR 3020 - Major Product Line within Division
    Minor Product Line within a Division
    Component within Product Line
    Subcomponent within Product Line
    Individual Contract
    Individual Line Items of Deliverables within a Contract

Individual elements of cost within a contract or within the separate line items of deliverables i.e., labor, material, overhead, G&A, and other direct costs.

Considering the above list of possible levels of renegotiation, it seems appropriate to ask the question: What makes one level more appropriate than another level for determining whether or not excessive profits exist?

I would suggest to you that a case could be made for at least the theoretical propriety of determining excessive profits at any of the above described levels. For example, the lowest level described above is at the individual element of cost within a contract. Assume labor cost on a contract is estimated at $20 million, but actual labor costs amount to only $11 million, giving rise to a potential $9 million excessive profit determination. The application of the statutory factors in the Act may give the contractor consideration for such things as efficiency and technological breakthroughs, thereby decreasing the actual excessive profits determination to $5 million for labor costs. At the same time, the contractor may have quoted $20 million for material costs and incurred actual costs of $25 million, or a $5 million cost overrun. Of course, this material cost overrun would be ignored, and not offset against the labor cost underrun, since renegotiation, in this example, is conducted at the level of individual cost elements within the contract.

Proceeding up the list of possible levels of conducting renegotiation, "Individual line items of deliverables within a contract" pose some interesting possibilities. Assume that the contracting parties have identified 10 separate deliverables under a contract and priced each of them at $10 million, amounting to a $100 million contract. Suppose one of the deliverables ended up costing only $5 million, and after application of the statutory factors an excessive profit determination was made for $4 million. In this example, assume the other 9 deliverables under the contract cost the contractor $110 million, rather than the $90 million originally estimated.

However, the government would ignore this $20 million loss on 9 items in the contract & focus only on the one item which had $4 million in "excessive profits."

The same procedure described above for conducting renegotiation by "Individual element of cost within a contract," or "Individual line items of deliverables within a contract" could be developed for all of the other possible levels of renegotiation described above. The practicality or fairness of these methods is quite another matter.

The proposed legislation would require renegotiation by division and major product line within the division, rather than any one of the several other alternates described above, for reasons which have not really been satisfactorily articulated. I have not seen any valid reasons presented for choosing product line renegotiation, over the several others that are certainly possibilities, since so called excessive profits can be measured just as effectively at any one of the above levels. There seems to be no conceptual reasons which favor product line renegotiation over the other possibilities. For example, why is it more of a ripoff of the American taxpayer to earn high profits on a product line basis, as opposed to, say, a single deliverable item within a particular contract or even a particular cost element, such as labor, within a contract. There appears to be no moral right or wrong attached to product line profitability as opposed to say, division of a company, or individual contract. There certainly is no ease of mechanical calculation of product line profitability over single company, division or individual contract; quite to the contrary, product lines are defined very differently by companies, and the Federal Trade Commission's attempt to develop uniform product line financial reporting in connection with line of business data was ill-fated, to say the least.

Choosing product line renegotiation, therefore, seems to be based not on any conceptually sound basis, but rather solely on the belief that it will result in collections of significant amounts of excessive profit by preventing large companies from offsetting low profit product lines against high profit product lines. The inappropriateness of product line renegotiation comes into sharp focus when it is understood how companies view the government market place in making pricing decisions, and the effect of such decisions on the prices paid by the government.

Companies view the government market place as to its total effect on the entire corporate entity, including affiliated companies, and not on a contract by contract basis, not on the basis of individual line items of cost within a contract, not on a product line basis, and not even on a divisional basis. This corporate marketing viewpoint has a direct affect on the pricing of individual contracts, including the individual elements of cost within a contract. For example, in pricing a highly competitive fixed price or incentive contract the contractor will forecast costs and profit that may be lower than permitted under the government regulations in order to arrive at a more competitive price. Under these circumstances, the government benefits from the lower price. In addition, the contractor runs the risk of overrunning the lower cost estimates, thereby further reducing the low profit margins already included in the cost proposal.

Why is the contractor willing to take such financial risks? Generally its because that particular contract, at that particular time, fits into the total corporate objectives, which could include a whole host of complex financial and marketing considerations, such as acquiring state of the art technology, retention of valued employees, sharing of common expenses, improved marketing position on identical or related products, or wanting to enter a new market. Regardless of the corporate reasons, I suggest that the Congress be aware of the fact that on price competitive procurements, regardless of whether the contracts are fixed price, incentive or cost type, contractors will propose costs that are less than could be justified under procurement regulations. There is nothing improper or illegal in doing so, and the government benefits from the lower contract prices that result from such pricing actions.

On the other hand, a corporate entity would ordinarily look for some balance in the degree of profitability of its products or services, so as to accomplish its present and future financial objectives. Balance in profitability is achieved in a number of ways. For example, underrunning cost estimates through cost efficiencies will increase profit. In addition, maximizing contract prices on those products or services not subject to intense price competition will achieve balance in corporate profitability. In negotiated government contracts, prices are legitimately maximized by including in cost proposals, for any type of contract, the maximum amount of cost and profit that can be justified under the government regulations. The process of negotiating contract prices, including audit by DCAA of proposal costs and review of historical cost data, along with other advisory services to the contracting officer, ordinarily permits the negotiation of prices deemed reasonable by both contracting parties.

CONTRACT OVERPRICING THAT PRODUCT LINE RENEGOTIATION WILL NOT CURE

It should be recognized that product line renegotiation will not help cure deficiencies in contract pricing such as, mischarging in government contracts, defective pricing by the contractor, and spare parts overpricing. All of these problems are addressed aggressively by the government in other legislative or regulatory actions. Nor will product line renegotiation recapture excessive profits resulting from poor contract negotiation by Government personnel. With the increased professionalism of procurement personnel, government has considerably improved its contract pricing capability.

A contractor is motivated for a number of reasons to mischarge costs in government contracts. Since these actions are oriented to specific contracts, and not to product lines which include several different contracts, the mischarging of costs and higher profits resulting from such actions will go undetected in product line renegotiation.

Similarly, defective pricing is applicable on a contract by contract basis. If undetected by the government, defective pricing may increase profit on a particular contract, but that contract will be grouped with many others to form product line renegotiation.

Spare parts overpricing may occur in a separate contract or as a separate line item within a contract. In any event the applicable contract will be grouped with other contracts for the same product and be subject to product line renegotiation.

When government negotiators fail to conduct adequate evaluation of proposed costs and hence negotiate unrealistically high contract prices, the higher profitability to the contractor will be merged with lower profit contracts in the same product line. As a result, the high profit contract will lose its visibility in product line renegotiation.

SPECIFIC ISSUES THAT EVIDENCE THE INAPPROPRIATENESS OF RENEGOTIATION BY DIVISION AND BY MAJOR PRODUCT LINE WITHIN A DIVISION

Definitional Problems

There are significant problems in obtaining agreement on a definition of a "product line." Companies will define and report financial data for internal purposes on product lines in quite different fashions. Some companies define product lines quite broadly, while others have very narrow definitions. Neither in external financial reporting nor regulatory compliance reporting is there a commonly accepted definition of "product line" financial reporting. Therefore, product line would have to be defined either by statute or in the regulations in a way that would be equitable for all contractors. The FTC attempted to do this for several years in its Line of Business Reporting and was relatively unsuccessful. Regardless of what definition of product line was finally adopted, it would undoubtedly require significant change in contractors' internal record keeping, because of the present diversity that exist among contractors in financial record keeping.

The Congress should be aware that a broad, high level definition of product line, for example a two digit SIC code, will yield lower excessive profit determinations than a product line defined at the lower level of three of four digit SIC code 5. A two digit SIC code definition will include a much higher volume of sales and profits, and hence inherently permit more offsets of high and low profits on contracts. In contrast, a three or four digit SIC code product line definition will not permit as much offset of high and low profit contracts, because of the lower amount of sales and profits in each product line.

While excessive profit determinations will increase at a lower level of product line identification, the cost of implementation by contractors and review by the government will increase dramatically. The development of new cost accounting systems and the cost of maintaining such systems by contractors will add significantly to the overall cost of renegotiation.

Negative Impact on Companies Who Perform Product Line Work in Two Divisions.

Renegotiation by product line within a division penalizes some companies because it fails to recognize some companies use two or more divisions to perform work on a single product line, rather than performing all the work in a single division. Under the circumstances when two divisions perform work, division A may have high profits, deemed excessive, and division B may have low profits for the same product line, but such low profits in division B would not be offset against high profits in division A. On the other hand, another company may perform all work on the product line in a single division, in which case high and low profits from various parts of the work would be offset, resulting in no excessive profit determination.

The existing language in the Act may cause companies to restructure divisional organizations and/or place government work in certain divisions only, rather that performing the work in the organizational or functional location that results in the most cost efficient performance. Either of these occurrences could cause government contract prices to increase.

Distorts Management Decisions on Seeking Government Contracts

Singling out the product line level for renegotiation is an artificial concept that fails the test of reasonableness from either the contractor's or government's viewpoint. Were product line renegotiation to become a reality, companies would alter their perspective of the government market place by making uneconomic decisions that would damage both the contractor and the government. Below are a few examples:

- Companies would tend to quote higher prices on high risk contracts, or not quote at all, because of the inability to offset low profits or losses against high profit contracts in different product lines. Developmental programs would suffer most because those generally are viewed as high risk involving several years of losses or marginal profits before contracts become profitable.

- Companies would devote more of their resources to the commercial market rather than the government market. This would be especially true in the case of subcontractors performing less government than commercial work, thereby further debilitating our industrial subcontractor base.

- Low profit product lines may be completely abandoned by contractors, leaving the government with fewer sources of supply. The management incentives to remain in certain product lines are varied and complex. Management may choose to remain in a low-profit product line because it tends to complement a high profit line in relation to marketing objectives, balance in product lines available, sharing of common expenses, ease of production, or because it provides work for the factory to attain higher plant utilization. However, these motivations may not be sufficient to continue in the low profit product line if the financial results are not permitted to be offset against high profit product lines.

- Faced with recapture of excessive profits on a single product line, companies will lose the incentive to maximize profit and tend to incur costs unnecessarily. The resulting lower profits will cause less capital to be available to improve operations, including lower investments in cost saving fixed asset improvements. This can cause price increases in product lines sold to the government.

Fiscal Year Renegotiation Will Erroneously Identify Excess Profits in Life Cycle of a Product Line

Fiscal year renegotiation is similar to a snapshot in the life cycle of a product and will improperly result in excessive profit determinations. Ordinarily, a product will be sold to the government for several years. In the early years, sales and profits are lower than in later years, when costs per unit tend to be less and higher profits earned as the product matures.

For example, in a multi-year procurement the same per unit prices are established for the several years of production, even though the amount of costs and sales will vary considerable by years, causing different amounts of profit to be earned each year. Certain years in the life cycle of a product, usually the later years, will result in higher profits that may be deemed excessive, even though over the life of the product profits are quite normal. Product line renegotiation on a fiscal year basis negatively focuses on this issue, and yields inequitable results by recapturing profits in certain years and ignoring low profits or losses in other years.

Sensitive Company Financial Data Will Become Public Information

Company financial data by product line is very closely guarded information, for valid reasons. Submitting such data to the government is quite different from submitting only total company-wide government financial data and the company has much more to lose in the way of confidential information. Product line financial data, in the hands of non-company personnel, can be devastating to a company's planning process, market analysis, competitive position, and future contracts. Notwithstanding government's efforts to safeguard the confidentiality of such data, it will, sooner or later,become public, or fall into the hands of non-company personnel.

COMMENTS ON REASONS ADVANCED BY OTHERS IN FAVOR OF RENEGOTIATION BY PRODUCT LINE

Those who advocate renegotiation by product line have, at various times, advanced a number of other reasons for its necessity. I would like to comment on what I believe are some of the more substantive reasons advanced. Since most believe that excessive profits occur in fixed price contracts, rather than cost or incentive type contracts, any examples are confined to fixed price contracts.

Contractor Earns More Profit Than Negotiated in the Price

Assume a contractor incurs less cost than estimated in pricing the contract, thereby earning higher profits than anticipated. If the contractor failed to disclose current, complete and accurate cost estimates at the cost proposal stage, he is guilty of defective pricing or fraud, both of which are covered by other statutes that provide relief to the government.

However, if the lower cost results from factors such as changes in market conditions, technological breakthroughs, improved efficiency or a simple error in estimating costs, these are normal business risks that any contractor serving either a commercial or government customer, in a fixed price contractual environment, is expected to undertake. If such factors were unfavorable to the contractor, resulting in a cost overrun, government would not be expected to increase the contract prices.

Government Disagrees with Cost Proposal and Contractor Says "Take it or Leave it"

Assume a contractor submits its cost proposal, using its judgment of cost estimates that government believes are too high and cannot be adequately supported. Contractor is adamant and will not negotiate lower cost estimates, or is willing to lower cost estimates to amounts deemed unacceptable by government. Contractor finally adopts a "take-it-or-leave-it attitude". There are several alternatives that government could consider i.e., change contract type to cost or incentive type, seek alternate sources of supply, cancel procurement, appeal to higher level management in company, or issue letter contract with price to be negotiated after actual cost experience. Pursuing one or more of these alternates is frequently done by government.

However, assume government does not pursue any of these alternatives successfully, and issues a fixed price contract consistent with the contractor's demands. Differences in judgment of contracting parties as to future cost estimates is present in most, if not all, negotiated contracts. Maybe the contractor is right and maybe the government is right. Only after the contract costs have been incurred will the amount of profit earned be known. This is the nature of a fixed price contract. However, the vast majority of these disagreements are negotiated to the satisfaction of both contracting parties. In those few cases where government ultimately disagrees, awards the contract on the contractor's terms, and higher profits than anticipated are earned, product line renegotiation is not the answer, because it will not recover excessive profits on a contract by contract basis.

In a broader sense it seems to me that government procurement practices are at fault to the extent that government believes it is paying too much for a particular item, and still awards the contract to the contractor. The recently enacted Competition in Contracting Act (CICA) should address the vast majority of problems in this area. It seems totally inappropriate to subject the entire defense industry to product line renegotiation, when such method of renegotiation will not address this particular contract pricing issue.

Sole Source Contractor Requires Higher Profit Than Government Believes is Reasonable

Assume sole-source contractor submits its cost proposal including an amount for profit that government deems unacceptably high. However, the contractor adopts a "take-it-or-leave-it attitude." Much of the same rationale described above, where cost estimates were the issue, also applies here. Product line renegotiation is not the answer in that it will not recover "excessive profits" on particular contracts. The real issue lies in government procurement practices covered, we believe, adequate by the newly enacted CICA.

Sealed Bid Contracting Can Result in Excessive Profits

Under a sealed bid contract, where the successful contractor submits only a bottom line price, market conditions, evidenced by little competition, can result in earning a profit that some may deem "excessive." Many of the old Renegotiation Board excessive project determinations occurred in this fashion.

However, under present procurement circumstances, this method of contracting is used by the government only when it is determined that sufficient competition exists to result in a price competitive procurement. Otherwise, a negotiated procurement will be conducted which brings into play all the pricing safeguards surrounding this type of procurement.

Renegotiation by Product Line Puts Large and Small Companies on an Equal Basis

Historically, most excessive profit determinations have been made against smaller companies with few product lines, in which cases company wide profits have been deemed excessive. In contrast, larger companies have been permitted, under the 1951 Act, to offset low and high profit contracts, so that the company as a whole did not have excessive profits. It is also held that mergers and acquisitions that have occurred since 1951 benefit large companies, by permitting higher volumes of contracts to be renegotiated as a group, further enhancing the possibility of offsetting high and low profit contracts.

The alleged benefit to smaller companies is influenced by the level at which product line is defined for renegotiation purposes. However, regardless of how product line is defined, it seems to me that smaller companies are in a no-win situation. For example, if product line is defined at a relatively low level of product nomenclature, smaller companies will find themselves subject to more excessive profit determinations than in the past. This is so because many smaller companies make a family of products, each of which could be identified as a separate product line, in which case excessive profit determinations against smaller companies would increase and continue to account for a large number of the total excessive profit determinations.

On the other hand, if product line is defined at a relatively high level i.e., airplanes and ships, excessive profit determinations against smaller companies would tend to be as frequent as in the past. Smaller companies tend to be involved in fewer product lines defined as broadly as airplanes and ships, thereby reducing the ability of the small contractor to offset high profits in one product line against low profits in other product lines.

In any event, most smaller companies would probably not support the legislation for product line renegotiation, since such companies aspire to growth which usually means broadening company activity to more product lines.

The Surge in Defense Spending is Causing Parts of the Defense Industry to Operate at or Near Capacity, Resulting In Excessive Profit Due to Lack of Competition

This potentially is a significant problem, especially at the subcontractor level, where the number of suppliers has been shrinking for several years.

Contract pricing by prime contractors or higher tier subcontractors can be accomplished by requesting only price, or cost and pricing data. If price only is requested from several vendors, under either sealed bid or negotiated contracts, and the buyer believes all of the prices are too high, requests for cost data can result in audit and negotiation of contract prices satisfactory to both contracting parties. This is permissible under the regulations and may have to be used more frequently in the future.

To the extent that the subcontractor is supplying a standard commercial type item, this is exempt from renegotiation and the amount of profit or loss on these products or services is no concern to the government.

One of the main sources of the problem lies in the fact that our country's industrial subcontract base is deteriorating. One of the many reasons subcontractors do not want to sell to the government is that it is an over-regulated business environment. The proposed legislation, if enacted, would simply compound the problem and cause more subcontractors to refuse to sell to the government prime contractors.

While most defense contractors do not earn excessive profits, renegotiation permits the government to recover from the few who profit unduly at the expense of the taxpayer.

With government spending billions of dollars for defense, there are always going to be some contractors, however few, guilty of wrongdoing such as overcharging, mischarging contract costs, defective pricing and fraud.

In considering the need for renegotiation legislation, the Congress should focus on whether or not there are any real excessive profits being earned by companies as a whole, the extent of such abuse, the existing laws and regulations aimed at such abuses, and the ultimate cost to the taxpayer of collecting such excessive profits from contractors, including the cost to contractors and government of complying with the legislation.

An honest evaluation of these issues would, I believe, result in the decision that new renegotiation legislation is not warranted at the present time.

Renegotiation does not drive the efficient contractor away from government business--to the contrary, consideration of the statutory factors rewards efficiency by permitting high profits but at the same time recovers excessive profit.

Some believe that contracting officers negotiate higher profits than warranted, and that renegotiation permits recovering these excessive profits through consideration of the statutory factors (efficiency, reasonableness of cost and profit, net worth, risk, and contribution to the defense effort). Some also believe that different measurements of profit, i.e. return on investment, or return on assets, can be used in renegotiation more efficiently in determining excessive profits as opposed to the Weighted Guidelines used by contracting officers to establish profit levels in negotiated contracts.

In my experience, contracting officers do a very effective job in negotiating profit in contracts. The Weighted Guidelines evidence thoughtful consideration of issues that are important in defense procurement.

On the other hand, I have always been bothered by the Renegotiation Act of 1951 that permits the use of criteria for determining excessive profit that are substantially different from criteria used in originally negotiating contract prices. The use of such different criteria, especially considering the subjective nature of the statutory factors, puts contractors at a distinct disadvantage in their financial relationship with the government.

This completes my testimony and I will be pleased to answer any questions you may have. Thank you for the opportunity to appear before you today.

Chairman HUBBARD. Thank you, Mr. Grenough.

We have questions for each of you.

Mr. Tolley, it is well-known by many of us here in Washington that you played an instrumental role in the effort to see that Vinson-Trammell Act rejected by the Congress. I am very familiar with your work regarding Vinson-Trammell.

Would you care to discuss the general concept of profit as a "percentage of price," as Vinson-Trammell dictated? And then discuss, if you would, the similarities of Vinson-Trammell to renegotiation.

In short, do you see the same things happening with renegotiation that led to the demise of Vinson-Trammell?

Mr. TOLLEY. Thank you, Mr. Chairman.

The Vinson-Trammell Act had a very specific profit limitation. This was fixed in law, a percent of sales, 12 percent on military aircraft and 10 percent on naval vessels. I believe those were the numbers.

It didn't recognize assets involved. It didn't recognize any of the business elements in contract performance. It was arbitrary in that it directly fit the model that I talked about earlier about the contractual relationship and the motivation for higher costs, so that as long as the profit percent stayed within the limits, no matter how high the cost went, they were still acceptable when costs were reduced. However, one exceeded the fixed profit rate and there was no incentive; as a matter of fact, a disincentive was there to reduce costs.

Renegotiation de facto has the same process built in. It is more sophisticated in that the Renegotiation Board, including that time period when Don Grenough was director of accounting at the Renegotiation Board, had to develop some method of determining when something was in excess or not. So over time, as with any bureaucratic organization, they established some sort of standards, even though they were a little loose, and there developed a pattern of what profit rates on sales, what profit rates on assets, what profit rates on capital—various criteria were considered to be appropriate.

There was the normal movement to an average. Whatever that average is, that became the norm. That is why I said earlier that profit limits, where they are absolute in law or where they are implicit in law, actually rewards mediocrity.

If the best you can do is the average, you are going to be OK in any of these procedures. But if your performance is excellent in all aspects and your profitability is very high, indeed even if it is justified, but it will fall under these sort of procedures. That is where I say categorically profit limitations are serving the wrong master in how they are implemented.

Chairman HUBBARD. Could I ask, please, Bill Tolley, you present to us for the record today as soon as you can your article entitled "Vinson-Trammel—An Anachronism" that was printed in the National Contract Management Quarterly Journal of September 1978? Could you do that?

Mr. TOLLEY. Yes, I will do that.

Chairman HUBBARD. We would like to have that for the record.

[The article submitted for the record by Mr. Tolley follows:]

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VINSON-TRAMMELL — An Anachronism

By James A. Herrmann* and William R. Tolley**

The Vinson-Trammell Naval Parity Act of 1934 provided for the modernization and enlargement of the United States Navy to levels authorized by the Washington Treaty of 1922 and the London Treaty of 1930. Although the country was not at war, the magnitude of the procurement activity resulting from the bill was likely to have a war-time effect upon the market place supplying naval equipment. Aware of several cases of profiteering during the First World War, the Congress felt it necessary to control profits allowed on procurements authorized by the Act. The Act was therefore amended to limit profit on any contract or subcontract for the construction or manufacture of naval vessels and/or aircraft to 10% of contract price. It specifially exempted contracts under $10,000 and allowed a permissive exemption to contracts for scientific equipment for communications, target detection, navigation or fire control systems. Moreover, the Attorney General in 1934 interpreted the profit-limitation provision to apply only to contracts for initial construction and manufacture and not to those for replacement parts. Originally, the law was implemented on a contract by contract basis. The Treasury Department was the agency responsible for its administration. Any "profit" in excess of ten percent of the price of a contract was recouped by the Internal Revenue Service.

Effect of Vinson-Trammell Profit Limitation

The use of a single measure, "profit as a percent of price", does not provide a total perspective of the financial operations of a firm. When combined with contract by contract application, the measure becomes even more narrow. In the case of the procurements authorized by the Vinson-Trammell Act, however, the use of such a restrictive profit limitation may have been the most expedient solution to what was envisioned as a short-term aberration in the market place. Unfortunately, its use was increased and it was applied over a longer period than was originally planned.

The inherent shortcomings of the profit limitation provision began to surface as experience with its application was gained and the scope of its use was expanded. The most obvious flaw in the provision was its contract by contract implementation. This approach required repayment of "excess" profit on an individual contract while ignoring insufficient profit or losses on other similar contracts for identical products. It must be recognized at this point that profit, as the term is used in government procurement, is not necessarily money in the contractor's pocket. This sum must be used to cover several business expenses which the government does not explicitly recognize as cost on its contracts. Examples of these are organizational and financing expenses and corporate contributions. Profit is also used to pay both interest on debt, and federal income taxes. The remainder may be paid out in dividends or reinvested in the firm.

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Congress resolved the inequity of single contract implementation by amending the Act in 1936 to allow companies to aggregate contract results before becoming subject to the profit limitation. Also, contractors received a credit for any losses incurred in the preceding year. In 1939, the Act was further amended to include the procurement of aircraft for the Army under the profit limitation and to raise the level of allowable profit on contracts for the manufacture of aircraft to 12%. An additional recognition of the risk associated with the manufacture of aircraft was that both losses and deficiencies in profit (i.e. less than 12%) experienced in the previous four years could be carried forward and set off any excess profit.

From the 1939 amendment until the present, the law has remained substantially unchanged. This cannot be construed as testimony to its lasting viability, but rather as evidence of its detrimental side effects. Application of the profit limitation provision of the Vinson-Trammell Act to the procurement environment during the WW II build-up did not contribute to the effectiveness and equity of the procurement process, but rather hindered it. Faced with the possibility of returning excess profit to the Treasury, contractors were motivated to increase costs on government contracts. Evidence at the time was that some companies performed government work in inefficient segments of their operations in order to assure that profit would not exceed the statutory limit. [1] In this environment, profit maximization was achieved through cost maximization rather than through productivity and cost reduction.

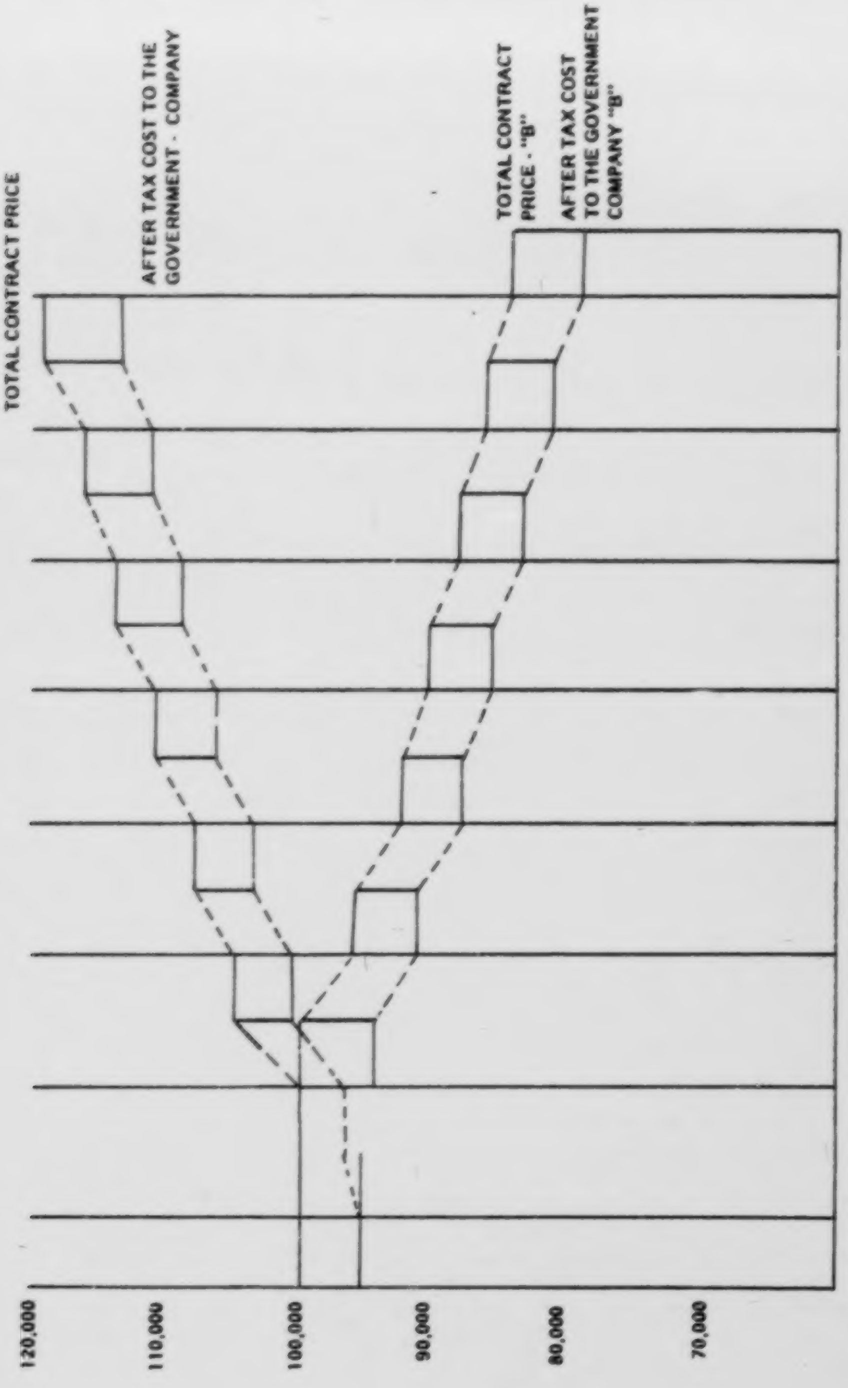
Profit, Competition, Profitability, Profit Limitations and Productivity

It is a fundamental fact that profit is good. This is demonstrated in the attached graph. Two companies, "A" and "B", are compared. In the first year, their prices and costs are identical. In the second year, "B" earns more profit. Although the selling price for each company is the same, the net cost to the government is lower with contractor "B". This is because the government shares in "B" 's profits through corporate taxes. An additional benefit of "B" 's performance is that it can offer lower prices in the future. In order for company "A" to earn more profit it must raise prices. The trend for each company is presented over an eight year period.

It is obvious that the government should wish to do business with company "B". Therefore, it should encourage company "B" to compete for its work. This competition would result in lower prices and would motivate company "A" to reverse its trend of rising costs and prices. If company "B" refused to bid on its work, the government would have no recourse but to deal with company "A".

Two common measures of profitability are return on sales and return on assets. A third is return on equity, however, this is merely a function of return on assets as they relate to a company's debt structure. When profit is limited to a fixed percentage of contract price, it is possible for a contractor to appear profitable without producing at the lowest possible cost. In such a case, a contractor's long run strategy would be to increase costs, increase price and thereby increase allowable profit. With no competitive incentive to invest in productive plant and equipment, inefficient contractors are able to return greater profit to a smaller asset base by keeping cost high. The result is that the profitability measures, return on assets and return on equity increase.

A contractor desiring to increase productivity and lower costs by substituting capital assets for labor must earn a higher percentage of profit on sales


TOTAL CONTRACT PRICE
AFTER TAX COST TO THE GOVERNMENT - COMPANY
TOTAL CONTRACT PRICE - "B"
AFTER TAX COST TO THE GOVERNMENT COMPANY "B"
120,000
110,000
100,000
90,000
80,000
70,000
3
4
5

in order to appear as profitable as his less efficient competitor. His increasing investment in assets increases the base of the profitability measure; therefore, this supplier has little or no motivation to enter into a contracting arrangement where profit is limited. This is the reason "B" refused to compete for government business after the third year. When efficient contractors do not compete for its business, the government must resort to less competitive suppliers. As a result, it pays higher prices for the goods and services it requires. Indications are that this was the case in the late 1930's. The Secretary of the Navy reported to Congress that competition for Navy aircraft contracts had decreased resulting in higher prices. [2] It is clear from the graphic presentation of Contractor "A" that after the fact determination of profit at a not to exceed rate reduces competition, increases cost and is analagous to cost-plus-a-percentage-of-cost contracting. [3]

There is no reason to believe that the profit limitations contained in the Vinson-Trammell Act are viable today or that the detrimental side effects which caused their abandonment will not occur again. Since the Act was suspended in the early 1940's, technology, the economy and the sophistication of defense procurement system have passed it by.

Changes in Defense Procurement

The defense procurement system has undergone dramatic changes since the end of the Second World War. The sophistication of the acquisition process has been increased legally, organizationally and academically. Legislative changes include P.L. 87-653, Truth in Negotiations and P.L. 91-379, Cost Accounting Standards. More subtle organizational changes include the establishment of the Defense Contract Audit Agency (DCAA), the Defense Contract Administration Service (DCAS), and the service plant cognizance program (AFPROS, NAVPROS and APROS). These statutes and organizations, as well as new analytical techniques and revised procurement methods, have enhanced the capability of the Department of Defense to independently evaluate contractor proposals and to negotiate equitable contract prices. The ability of DOD to effectively perform this function precludes the requirement for any type of renegotiation in peace time.

Current Need For Vinson-Trammell

Present day enforcement of the Vinson-Trammell Act is *unnecessary, arbitrary, uneconomical, inflationary* and is *not in the best interest of the taxpayer.*

a) Profit limitations are unnecessary because DOD is able to ensure fair and equitable prices and is not negotiating under duress. "Should cost" reviews, pre-award surveys, post award audits, truth in negotiation requirements, and cost accounting standards are all means through which the government is able to determine and validate negotiated contract prices. There is no need to redetermine profit. Even in times of national emergency, it is doubtful that the government would not have adequate data with which to establish reasonable prices. In cases where there is insufficient data upon which to establish a firm price, attention should be given to the appropriate contract type (FPI, CPIF, CPFF, etc.) rather than to profit limitations.

b) Enforcement of Vinson-Trammell is arbitrary because it uses a single profit limitation set in 1934 and it is vague as to which contracts it applies. Economic and business conditions have changed since the law was enacted. In 1934 the country was in a depression and 10% or 12% profit before federal taxes may have provided a reasonable rate of return on investment or equity. Since other rates affect the profitability of a firm, one cannot strictly look at profit on sales. Inflation, asset turnover, corporate tax and interest rates are but a few of the remaining determinants of a company's ultimate profitability. Another factor contributing to the uneven impact of Vinson-Trammell is that military systems have become so complex over the past forty-five years that they are not simply classified as ships or aircraft. The profit limitation applies to the lowest tier subcontractor thereby compounding the problem presented by system complexity. It may take years to non-productive, expensive litigation to determine the intent of the law in 1934 and the contracts to which it applies today. Lastly, the $10,000 contract threshold to which the law applies is unrealistically low. In today's procurement environment, a more appropriate threshold would be $5,000,000. [4]

c) Enforcement of the Vinson-Trammell Act will not be economical. It requires the reactivation and implementation of a reporting system within the IRS and industry in order to determine excess profits which are not likely to exist. In a report to Congress regarding the Causes of Excessive Profits on Defense and Space Contracts (PSAD 76-56 DEC 31, 1975), the GAO reviewed Renegotiation Board determinations of excess profits during FY 70 through FY 73. In this report, the GAO concluded that "contractors found to have made excessive profits in fiscal years 1970-73 were primarily small producers of relatively low technology products such as military apparel and ordinance, and they were concentrated within relatively few industries and product lines". Since these types of procurements are not affected by Vinson-Trammell, it is evident that the manpower costs incurred by the government and industry in reporting alone are likely to exceed any excess profits recouped by the IRS. Neither government or industry can afford to waste resources in unnecessary reporting and costly litigation.

d) Enforcement of profit limitations will be inflationary. The appendix demonstrates that the use of a fixed percentage profit limitation will drive the efficient supplier away from the government market. The government, having no recourse but to buy from the inefficient producer, must pay higher prices for the goods and services it requires.

e) The appendix indicates that, even when selling prices are identical, the lowest total cost to the government as a whole is provided by the more profitable supplier. This is because a portion of profit is returned to the Treasury. Therefore, it is in the public interest to ensure competition and profitability. Enforcement of the Vinson-Trammell Act would eliminate this phenomenon of the competitive market place.

Unnecessary government functions, arbitrary actions leading to expensive litigation, costly witch hunts for non-existent "excess" profits, high prices and legislation which would spur inflation in defense spending are not in the interest of the American taxpayer. By repealing the archaic and potentially damaging profit limitations of the Vinson-Trammell Act, the Congress can move to reduce unnecessary government activity and to restore the incentive for productive performance in the defense market place.

APPENDIX

In this hypothetical example, two identical companies make radios for the government which is their sole customer. The companies started out with equal production facilities, costs and selling prices. After the first year, they pursued different strategies. One company began to liquidate its asset base and let its equipment become antiquated. The other company invested in productive plant and equipment in order to reduce costs. Both companies will be analyzed using two measures of profitability. The first measure is profit on sales. This is computed by subtracting production costs from selling price which yields earnings before interest and taxes. These earnings divided by sales equal profit on sales. It is this relationship that is limited by Vinson-Trammell legislation*. For purposes of the example, the limit for this ratio is set at 10% of sales. The second measure of profitability is return on assets. This is computed by dividing earnings by total assets. This value indicates the amount of earnings before taxes available to creditors and stockholders. It is one of the key ratios used by the financial community in judging the viability of a firm. By providing an adequate return on assets, a firm is able to attract the capital it requires for investment and growth. These two, as well as other financial ratios, affect each other. When one, such as profit on sales is limited, various strategies pursued by firms can lead to situations in which the inefficient firm appears more profitable than the efficient one. The appendix will explore this phenomenon as well as demonstrate that the efficient producer always provides goods and services at the lowest total cost to the government.

In the example, each company has an initial order to produce one thousand radios per year on a two year contract. The selling price of each unit is fixed at $100.00 for both years. In the first year, both companies had unit production costs of $90.00.

The initial year balance sheets for the companies read as follows:

Current Assets	$ 70,000	Current Liabilities	$ 39,000
Plant & Equipment	20,000	Long Term Debt	15,000
		Owner's Equity	36,000
Total Assets	$ 90,000	Total Liabilities & Equity	$90,000

Sales for both companies in the first year were:	$100,000
Cost of production and administrative expenses equalled:	90,000
The net margin was:	$ 10,000
Margin/Price = 10,000-100,000	10.00%

With the $10,000 margin the companies have earned a 10.8% return on average assets of $92,350. With these earnings they must pay $1,000 on their long term debt and $4,300 in federal income taxes.

At the beginning of the second year, each firm was at a decision point.

Company "A" decided to pay out all its earnings in dividends. Rather than overhaul old equipment, it used funds provided by depreciation to buy back some outstanding stock. To compensate for increased maintenance on old machinery, the company enlarged its work force. This increased unit production costs by $2.50 to $92.50.

Company "B" reinvested both funds provided by depreciation and its prior year's earnings in new plant and equipment to refurbish existing capacity and increase production efficiency. In doing so, it reduced unit production costs by $2.50 to $87.50.

*Vinson-Trammell limits profit to a percentage of contract price. For simplicity in the example, price equals sales.

The results from the second year were:

	Company "A"	Company "B"
Sales	$100,000	$100,000
Costs	92,500	87,500
Margin	$ 7,500	$ 12,500
Margin as a % of price	7.5%	12.5%
Average assets	89,450	97,700
Return on assets	8.4%	12.8%
Interest expense	1,000	1,000
Taxable earnings	6,500	11,500
Taxes	3,100	5,500
Net earnings	3,400	6,000
TOTAL COST OF U.S. GOVERNMENT		
Sales dollars paid	$100,000	$100,000
Tax revenue received	3,100	5,500
Net cost	$ 96,900	$ 94,500

Considering the additional tax revenue received, the government paid less for the products it purchased from Company "B". Company "B" was also more profitable than Company "A" in both return on sales and return on assets.

Company "B" exceeded the statutory limit of 10% on price by earning 12.5%. Company "A" was under the threshold. The IRS must redetermine Company "B" profits. The calculation is as follows:

Net Margin (Company "B")	$12,500
Less: Statutory Limit of 10% on Price of $100,000	(10,000)
Excess Profit	2,500
Less: Credit for Portion of Income Taxes Paid Applicable to Excess Profit	1,200
Payable to U.S. Treasury	$ 1,300

Effect of Profit Limitation on Company "B":

	W/ Limit	W/O Limit
Margin	$10,000	$12,500
Average Assets	97,050	97,700
Return on Assets	10.3%	12.8%

In the third year, the government had a requirement for another two thousand radios. so it negotiated follow on contracts for one thousand radios each to Company "A" and Company "B". This was the first opportunity for the firms to adjust price. Company "A" continued to pursue its strategy of substituting labor for capital and reducing its asset base. Under the truth in negotiation act, it was able to certify that its costs were increasing and that they were estimated to be $95.00 per unit. Therefore, the government and contractor "A" agreed to a contract price of $105.00 per unit.

Company "B", on the other hand, had been increasing productivity and lowering costs. Its certificate of cost and pricing data indicated this trend. The government benefited from Company "B"' productivity increases through reduced contract prices. Company "B" estimated costs to be $85.00

per unit and negotiated a contract price of $96.00 per unit. The results of the third year follow:

	Company "A"	Company "B"
Sales	$105,000	$ 96,000
Costs	95,000	85,000
Margin	10,000	11,000
Margin as a % of Price	9.5%	11.46%
Average Assets	85,600	102,000
Return on Assets	11.7%	10.8%
Interest Expense	1,000	1,000
Taxable Earnings	9,000	10,000
Taxes	4,300	4,800
Net Earnings	4,700	5,200
TOTAL COST TO U.S. GOVERNMENT		
Sales Dollars Paid	105,000	96,000
Tax Revenue Received	4,300	4,800
Net Cost	$100,700	$ 91,200

Company "B" is less profitable than "A" when viewing return on assets, but is more profitable when return on sales is considered.

Again, the lower price combined with the increased taxes it paid made Company "B" the lower cost supplier to the government. However, in this year, Company "B" begins to appear less profitable than Company "A". Company "B" exceeded the 10% statutory threshold of profit on price. Therefore, profits were redetermined. The calculation is as follows

	Company "B"
Net Margin	$11,000
Less: Statutory Limit	(9,600)
Excess Profit	1,400
Less: Credit for Portion of Income Taxes Applicable to Excess Profit	(670)
Payable to U.S. Treasury	$ 730

Effect of Profit Limitation on Company "B":

	W/ Limit	W/O Limit
Margin	$ 9,600	$ 11,000
Average Assets	101,635	102,000
Return on Assets	9.4%	10.8%

By reducing costs, Company "B" was also able to reduce prices. Since profit is limited to a fixed percentage of price, reduced costs yield reduced prices which result in reduced profits. Conversely inefficiency leads to high costs, high prices and high profits. This is only true when contractors operate under a profit limitation.

By substituting labor for capital, raising its costs, liquidating its asset base and buying back stock, Company "A" became more "Profitable" than Company "B". In fact, under a profit limitation, Company "A" 's actions were more rational than "B" 's.

If both companies pursue their chosen strategies and continue to do business with the government, Company "A" will continue to deplete its asset base and costs will remain high. Therefore, it will appear "profitable".

TABLE 1

Comparison of Contractor Profitability

Contractor "A"				Contractor "B"					
					Without Limitations			With Limitations	
PRICE	COST	PROFIT on Sales (%)	R on A (%)	PRICE	COST	PROFIT on Sales (%)	R on A (%)	PROFIT on Sales (%)	R on A (%)
$100.00	$ 90.00	10.0	10.8	$100.00	$ 90.00	10.0	10.8	10.0	10.8
100.00	92.50	7.5	8.4	100.00	87.50	12.5	12.8	10.0	10.2
105.00	95.00	9.5	11.7	96.00	85.00	12.9	10.8	10.0	9.4
108.33	97.50	10.0	13.3	92.36	82.50	11.9	9.5	10.0	8.9
111.11	100.00	10.0	14.5	90.34	80.00	12.9	9.5	10.0	8.3
113.88	102.50	10.0	15.7	88.30	77.50	13.9	9.5	10.0	7.7
116.66	105.00	10.0	17.2	86.30	75.00	15.1	9.5	10.0	7.2
119.44	107.50	10.0	18.8	84.30	72.50	16.3	9.4	10.0	6.7

Company "B" 's profitability will continue to decline and it will begin to experience difficulty in attracting the investors and creditors required to finance additional growth.

Table I indicates the performance of the two companies through the first three years. It also projects performance for an additional five years. An analysis of contractor "A" indicates that by allowing costs to rise and controlling them to the point of maximum profit under the limit, he can recover costs plus profit at a fixed percentage. In attempting to stabilize his return to creditors and stockholders, contractor "B" must earn a greater percentage of profit on sales. When this profit is retroactively redetermined, however, he becomes much less profitable than "A" and unattractive to investors. Although he can offer a lower price to the government, contractor "B" refuses to bid. This leaves "A" as a sole source and results in the technical equivalent of cost-plus-a-percentage-of-cost contracting.

FOOTNOTES

[1] Roger N. Boyd and Donald C. Holmes, Jr.; *Memorandum of Law* RE: Analysis of liability of government contractors for excess profits resulting from the reactivation of the Vinson Act, pp 13.

[2] Ibid pp 12.

[3] The Appendix provides more detail regarding the case example provided.

[4] The average unit cost of the B-17 approached $200,000 (U.S. Army in WW II, V8, Pt. 7, by Irving Brinton Holley, Jr.). This figure compared to the $100,000,000 projected unit cost of the B-1 results in a ratio of 500 to 1.

Chairman **Hubbard**. Mr. Mulligan, on page 3 of your testimony you refer to the spare parts horror stories. You also go further to state that there is a rational explanation for each one, but you don't state specifics.

Briefly, would you recreate a scenario, if you can, that would lead to a situation such as the $7,000 or $6,000 coffeepot like we have heard about earlier today? In other words, would you briefly describe the cause of such a situation and why you believe it is not excessive profits? Most people who hear about a $6,000 coffeepot are assuming that it is excessive and that there is fraud. They are critical of defense spending and make fun of the Pentagon, and we have people in Congress who make long speeches about excess spending by the military.

Will renegotiation solve this?

Mr. **Mulligan**. No, Mr. Chairman. Unfortunately, as I said, there are answers to those, but they don't play; they don't sell papers.

Take the coffeepot. The first mistake, it is not a coffeepot. Next time you fly in a DC-10, look at what they have there. It is a coffee assembly station. I am not in that business, except I know what it looks like and I know that—what Eleanor Spector was saying—there are different reasons for each of those horror cases. One is overspecification. I think that coffee assembly would make tea and coffee, and make anything you wanted at 300 degrees above zero, 300 degrees below zero, at 20G's, when the plane was going down. I think if the plane crashed, it would still be perking coffee for the rescue crew that got there.

Whether we need that overspecification or not is something else again, but that is part of your reason.

The other part is this cost allocation situation. We mentioned it earlier—how you allocate overhead. For some reason now, with 20-20 hindsight, it is just dumb. The allocation was made on a per item basis. So the singular item of a 4-cent diode or hammer or whatever got the same allocation as the more expensive $100,000 piece of test equipment.

This does not indicate to me there is any excessive profit, because the cost to the contractor for making both of those items has been absorbed. It is a question of how it was allocated.

I have been trying to preach this message. I have talked to the Rotary, Kiwanis, and so forth. That is the only way you get to your constituents. You can't do it any other way. It is unfortunate.

I can sympathize with the Congress because you have a problem. Congressman Gonzalez mentioned the Wall Street Journal article. He said here is a prestigious paper who, in their lead article, on page 1, talks about DCAA and ends up calling them a toothless watchdog. Now, a lot of people read that paper and believe it.

I was interviewed by that same reporter for over 1 hour for my views on the DCAA, and I can tell you I didn't call them a toothless watchdog. I explained exactly what DCAA has been doing over the past years, but did that appear in the paper? Not one single word. Was I offended because they didn't use my name or my quotes? Heck no. I was offended because it was a distorted story. That is the basic problem we have to fight.

The constituents come up to you and say we have to do something about this. The Congress says yes, let's pass legislation. You do that. And, as Eleanor said, as a result of the CICA, Competition in Contracting Act, they have to go and rewrite all the regulations. One-third of the regulations had to be rewritten.

Sure, it can be explained. You can explain all those things. I explain it by one of the simplest ways, and people say I never heard it explained that way. I say you are sick in bed, you can't go shopping, you ask somebody to come in, and say, take a look at my pantry, find out what I need, go down and buy it, make sure it is right, make sure it is properly done, bring it back, put it away, do it all, and I will pay you $20.

You have 20 items. Unfortunately, one of them is a steak and one is a roll of toilet tissue, one roll. It costs a quarter. The 20 items, the $20 allocated, $1 to each. You don't complain about the steak if it is $10.95 instead of $9.95, but you raise hell about one single roll of toilet tissue costing $1.25. It is just as simple as that how they allocated the cost.

But does that story get told? No, because the explanations don't go over. Does it mean excessive profits? No. The $20 was a good price for what you got. It is how it was allocated.

So I don't believe those isolated horror cases are any reason at all for indicating they are excessive profits in our industry.

Chairman HUBBARD. Those of us in Congress can understand and believe your comments about the media leaving out certain parts of your explanation.

Mr. MULLIGAN. There were more media personnel here when Mr. Kaufman was talking than there are now. But then again, that is to be understood.

Chairman HUBBARD. We thank you, Mr. Mulligan.

Again, I appreciate Dr. Bruce Benefield being with us in addition to your being here.

Now, Don Grenough, let me ask you one question, and then I will turn it over to my colleagues. On page 24 of your testimony, you state:

> In considering the need for renegotiation legislation, the Congress should focus on whether or not there are any real excessive profits being earned by companies as a whole, the extent of such abuse, the existing laws and regulations aimed at such abuses, and the ultimate cost to the taxpayer of collecting such excessive profits, including the cost to contractors and government of complying with the legislation.

Does it make sense to you for Congress to first determine if there are excessive profits before we go ahead, before we go one step further and try to prevent them?

Mr. GRENOUGH. I think this focuses, Mr. Chairman, on the issue I mentioned in my summary statement to the effect that the level at which so-called excessive profits are to be sought after is a very, very critical point. The proposed legislation deals with a level called product line. I have indicated in my paper why I see no conceptual basis or logic for product line as opposed to any other level that I have articulated in the paper.

I am concerned when people propose legislation that gets away from the total company concept, the total company was the way renegotiation was conducted for years. It was passed in the wisdom of the Congress in 1951. I have not seen anything on the record that tends to articulate in a way that at least I can understand what makes product line an appropriate level to conduct renegotiation.

I think the initial thing is to get through that conceptual problem. And once that is solved, then one could perhaps determine whether or not excessive profits are in existence.

I personally, in my experience with my concept of excessive profits, which is oriented to a total company concept, I really don't believe considering all the improvements in the procurement processes over the years—and I have been in the business for almost 40 years—that there is not really in today's environment excessive profits that should concern either the Congress or the taxpayers.

Chairman HUBBARD. I did say one question, but if my colleagues would grant me one more, I would appreciate it.

You devoted a substantial portion of your time to the discussion of product line renegotiation. To the best of your ability, can you estimate what percentage of companies nowadays keep their records by product line?

Mr. GRENOUGH. Well, in my experience—and we work with several hundred different companies a year—most companies will keep some sort of financial data by something that they define as a product line. The problem, Mr. Chairman, is that there is no uniformity in a definitional sense among companies as to what is a product line. Some companies will have, for example, $100 million in sales and might bookkeep their sales and costs in three or four broadly constituted product lines, where another much smaller company, a $20 million a year company, for internal management purposes may have 10 or 12 or 15 so-called product lines.

There is no uniformity among defense contractors in terms of how they define product lines.

Chairman HUBBARD. Congressman McCandless.

Mr. MCCANDLESS. I would like to reserve my time, if that would be in order, Mr. Chairman.

Chairman HUBBARD. That is fine.

We will call on Congressman Gonzalez.

Mr. GONZALEZ. Mr. Chairman, I don't have so much in the way of questions, except that I feel impelled to make a couple of statements.

To clarify the record, I believe that the impression Mr. Tolley has left is that the Vinson-Trammel Act had been invoked at any time between 1951, 1955 and onward during the active period of the Renegotiation Board, so that when we boast about doing away with the scarecrow—which, incidentally, was used as an argument at the time they were willing, the Renegotiation Board—but I think the record ought to show that nobody was pushing for Vinson-Trammell, and that in the absence of a process that the Renegotiation Board exemplified that then this boogieman of the Vinson-Trammel invocation scared the daylights out of everybody, and you had to have specific repealer legislation. That is one.

The other was your, I think, rather inappropriate analogy to homebuilding. As a matter of fact, we have a very, very good illustrative track record with the so-called new construction section 8 housing in which, if there was ever to be an equivalent in the Renegotiation Board process in the home construction business, that certainly was a good one.

In fact, the Congress abandoned it just a couple years ago because of the fact that the cost factor was just out of control.

So that in both cases—though I think that I just feel the record ought to clarify those points—all I can say is that of the three witnesses, I think that we can synthesize their testimony very succinctly by saying that each one says, "Who says there is an excess profit problem? Show us."

And you go on and profit before you go around here fiddling around with legislation, legislative proposals. In the meanwhile, we will fight you to death to try to get processes and programs that will enable you to establish the extent of excess profits.

So with that kind of position, it would be kind of silly for me to ask questions.

Chairman HUBBARD. Mr. Tolley.

Mr. TOLLEY. May I respond?

I am sorry if I implied that Vinson-Trammell was in effect during the time of the Renegotiation Board.

Mr. GONZALEZ. You certainly did.

Mr. TOLLEY. It was not in effect. As a matter of fact, the Renegotiation Board was a temporary act that superseded temporarily the Vinson-Trammell Act.

Mr. GONZALEZ. That is right.

Mr. TOLLEY. My purpose of talking about both was to talk to the analogy between the two as far as their comparability of impact.

Chairman HUBBARD. Mr. McCandless, questions?

Mr. MCCANDLESS. Thank you, Mr. Chairman.

I appreciate the testimony that you three have given and the patience in waiting until this time of the day. One of the things that seems to be with us in this process of contracting is that if you contract with some level of Government—in this case the Department of Defense—that there are additional costs beyond that of the obvious, materials, manpower, et cetera, and interpreting regulations and having additional inspections and numerous other things which automatically add to the cost of an item being sold to the Federal Government that would not be represented in the same kind of item if it were designed and built and sold in the open market.

Many people tell me this is true. I have had limited experience in the area and I can kind of think it is true. Is anyone in the business sector, has anyone done an analysis of how much more it costs to do business with the government than it would the private sector in a like situation? Any of you who may have thoughts on that, I would like to hear from you.

Mr. MULLIGAN. As far as a comparison, I think in our company we have a commercial division producing commercially and we have the government division and groups, and it is pretty clear that we get quite a bit more help, or assistance. I think Congresswoman Kaptur was referring to the trailers outside of Teledyne in Toledo. We would need quite a few trailers.

We have over 150 people helping us. Is it all necessary? It is added cost, that is for sure, not just the cost of the people but what they ask for and what we have to respond to, the housing of them, et cetera.

Do they help on quality? I am not a technician in that area, but there are a lot of people on contract administration, tremendous amount. Every time Congress passes another bill they have to make sure that it is being followed so they come in and check up and make sure that the bill is being implemented properly.

So, yes, it sure does raise the cost. There is no doubt about it. The question is, Do you know, is that worth it and to what degree? What we are talking about is adding another one, add another board to it. I think that clearly that is an area that hopefully this new commission will look at. We would certainly encourage them to look at that.

Can the organization be reorganized differently so you don't need all that help?

Certainly you will have to have auditors when you are dealing with taxpayers' money. But they are not all auditors. There are a lot of other folks out there helping us.

Mr. McCANDLESS. Yes.

Mr. GRENOUGH. While I don't have any specific figures that would be useful in the sense of greater percentage of dollars that are required to do business with the Government, Mr. McCandless, in my experience as a public accountant working with a host of companies each year large and small, I think the Congress should be aware that lots of the smaller companies—by that I mean companies less than $40 or $50 million a year sales—a lot of those companies don't want to do business with the Federal Government because of the bureaucratic hassles and regulations and oversight we have discussed before. This is important to me as a taxpayer because I volunteered several months of my time on the Grace Commission and worked specifically in the area of DOD in relation to procurement issues. One of the things that we tried to focus on was the deterioration of our subcontractor base in this country. I think that things like a multitude of regulations, including the consideration for development of a board, all it does really is force subcontractors further away from doing business with the Government.

As a country, I don't think we want to do that.

Mr. MULLIGAN. Hewlett-Packard was mentioned earlier as being a large Government contractor. They sell equipment through GSA, off the shelf, catalog items, but to this day refuse to accept a Government contract that will call for the application of cost accounting standards and other Government regulations, this is, negotiated contracts.

They refuse to accept it for the very reasons that Mr. Grenough just cited. They don't want to get into that redtape. There are quite a few others like that.

Mr. TOLLEY. We have attempted to discretely identify costs in the past on a couple occasions when we have been asked this, however, this is a very nebulous thing to get a handle on. It is because the organization of a business entity to do business with the Government is different than it is in the commercial division. We can take two of our divisions, the same comparable size, and they are oriented different.

We can look at the end product. Just take a semiconductor, for example. We know today that we are selling commercial semiconductor products, better in its performance, than the military semiconductor, and several times cheaper. It is because of the specifications surrounding them. Many military specifications are archaic, old and outdated. More testing is required. More inspection. But they may perform less.

It is this collective system with the cults built into the Government procurement system, such as reliability. They have their specification and their whole organization that must be impacted on the product, for example, inspection, et cetera.

The difference between commercial operation and a Government systems operation are marching to all the Government requirements is a horse of a different color, and it is hard to get a handle on it.

Mr. McCANDLESS. How do you break this chain? You Mr. Grenough, were with the Grace Commission. I have a lot of respect for the end product. How do you break this chain that has been with us since George Washington and George Patton who were mentioned earlier, I guess maybe George Washington may have had some problem with it.

How do you slow it down? How do you reduce all this?

Mr. GRENOUGH. My opinion, Mr. McCandless, is that it would take some pretty deep surgery which we as a country may not be in a position to do now. We as a country may not get too excited about something until the straits become more narrow, we come to be in a more dire situation. I don't know if we can do the deep surgery that we need.

A number of the Grace Commission recommendations were, I thought, pretty dramatic and frankly when we discussed many of those issues with DOD, they were concerned about the nature of some of them. They were rather drastic.

A number of them would have required legislation.

Just to get specific, my concern about the subcontractor base is, and I believe the way you minimize excessive profits, however it is defined, is to maximize the competition in the country. The Competition in Contracting Act which was passed and effective this year is I think a great step forward.

In addition to that, we have got to, as a country, find some way to get subcontractors more interested in doing business with the Government. The Government has to be perceived as a better customer. One of the ways and only one is to cut away massive amounts of the regulatory environment at the subcontractor level.

Prime contractors know how to deal with this. I am not condoning it, but they know how to deal with it, they are structured to deal with it, they have people, policies, and procedures.

The smaller subcontractor who has never worked for the Federal Government doesn't want to get into that hassle and that is where we are losing a high degree of competition that would help lower prices.

Mr. McCANDLESS. Yes.

Mr. MULLIGAN. One way you can get at it is first of all, if you look at what we have now, as I say a good part of it came out of the legislative process, is to stop where we are now and give it some time to see with what you have all been doing in the past few years is working rather than heaping on new legislative requirements.

I think Eleanor Spector said earlier today, they cannot hardly keep up with it. I am sure she is down here spending a good part of her time as her predecessors have, they are so busy defending what they are doing down here they don't have the time to do the work that is required from legislation of a year before.

The learning curve is very difficult to get people into this business and to understand what the laws are. I have been in it 40 years, and I can tell you it changed dramatically over the years.

So that makes it very difficult to get people up to speed. This Competition in Contracting Act is a tremendous change. The authorization act has a whole bunch of new things in it that we will have to start from scratch on again.

I think we have to kind of call a halt and get a focal point on it and see what is going on, live with the laws that we have before we decide we need new ones. But this knee-jerk reaction to the press which says we have to do something and pass a bill is just creating more paperwork that will get us so far bogged down that you will soon have more horror cases because you cannot keep up with it.

Mr. McCandless. Thank you very much.

Thank you, Mr. Chairman.

Chairman Hubbard. Thank you, Congressman McCandless.

We will be finished before 4 o'clock.

Mr. Mulligan, you referred to the Truth in Negotiations Act as one of the laws in existence in 1979 on which Congress relied in its determination to terminate the Renegotiation Board.

The deputy inspector general of the Department of Defense, Derek Vander Schaaf, went on record on October 3 this year by saying, "the Truth in Negotiations Act is the best means the Government has to prevent contractors from reaping unearned and excessive profits on contracts."

Mr. Vander Schaaf, the deputy inspector general of the Defense Department, stated further the act, "supported by good definitive pricing audits, would be much more effective in eliminating excessive profits than any of the renegotiation proposals."

Do any of you want to comment on his comments?

Mr. Mulligan. Well, I certainly would agree. As I mentioned earlier, it has more teeth now than ever. Because of the fact you could have had an inadvertent omission of current complete and accurate data, the burden is on the contractor to prove it was inadvertent and it was not fraud.

I would agree. DCAA comes in and looks at fixed price contract and they see the price and they see the cost and they know what the profit is. If the profit is to pick a figure, say, 35 percent, if you are a good auditor what are you going to assume? You will assume the contractor must have done something in his current, complete and accurate pricing that was deficient, otherwise how could he have made so much money. How could he have made so much profit? It must have been defective.

So the contractor is on the defense and he has to go through and prove it was not obtained in that manner and yes, they have one heck of a big club today to use. Because in addition to adjusting the contract price and returning the profit, now they can get you on fraud. I think that is a tremendous weapon as I said. We have to reeducate all our people that it is just not an error, you have to be darn sure this will operate this way.

Fraud is a lot different than defective pricing.

Mr. TOLLEY. Mr. Chairman, believe the Truth in Negotiation has been a very, very effective tool since it was enacted in 1962 and subsequently implemented.

It establishes up front a factual record of what information was supplied and if one deviates from that, in effect, supplies misinformation or the lack of information, there is an ability for the Government to revisit the point of negotiation when the contract deal was struck.

That is the place it ought to be done. So I think it has been a very effective tool and many, many contract audits have been run and a number of contract adjustments have been made. Industrywide facts and data I don't have, but I know in our company we continually have these audits being run, probably 20 or 30 in a division at any one given time.

I would like to sound a note of alarm and that is what Dick Mulligan earlier referred to as the possibility of many of these actions being called fraud.

I think as a society we are moving in the wrong direction. The U.S. Government should not be writing laws which would have ordinary business activity—conduct in the negotiation give and take process of a customer and supplier—called fraudulent activities. I think the trend right now is going far beyond what in the normal marketplace is accepted as part of the negotiation process, a commercial, nongovernment business entity would be very, very surprised with what the Government is now claiming to be as fraudulent activity.

So I think this is going to drive competent business people out of the marketplace. They will not want to do business in that sort of an environment. It is one thing to say your contract price might be adjusted slightly, it is another thing to imply that you may go to jail if you have not told the whole truth and nothing but the truth, so help you.

Chairman HUBBARD. Mr. Grenough, any final remarks?

Mr. GRENOUGH. I am going to simply echo agreement that defective pricing in my experience has been very effective legislation. I had the opportunity to have worked in GAO during the time that legislation, during the time the audits were performed that ended up in that piece of legislation, and I think that legislation serves to put the Government on an equal footing with the contractor, because the thrust of that legislation is that a contractor shall share all factual data with the Government prior to the time that the contract price is agreed to.

The extent to which he fails to do that, he is guilty of defective pricing and a unilateral change, decrease in the price, can result.

Chairman HUBBARD. Each of the members of the subcommittee can say as each of you have from the witness stand that we are all opposed to excessive profits by defense contractors. It is the approach we take to solve that problem which is up for discussion and the issue of concern.

I want to especially thank my colleague and friend, Congressman Henry Gonzalez, the sponsor of the bill we have taken up today, H.R. 3020, the War Profiteering Prohibition Act of 1985, a measure to revise and reenstate the Renegotiation Act of 1951.

To you, Bill Tolley, Dick Mulligan, Don Grenough, we appreciate your testimony.

As we conclude today's session on H.R. 3020, I would mention that our original plan of course was to have had hearings last Thursday and our second hearing today. However, due to the inevitable postponement of last Thursday's hearing, we will reconvene at a time yet undetermined to take additional testimony from witnesses who would like to testify on this legislation.

We hope you can attend, inasmuch as we expect our witnesses to provide additional, helpful, interesting input on this important issue.

Should anyone have questions as to when our next hearing on H.R. 3020 will take place, please call our staff locally at 225-2828 in the Rayburn Building.

In mentioning the staff, I would like to thank Mary Martha Fortney, staff director; Greg Carter, counsel; Pam Satterwhite, clerk; Harold Garrison, legislative assistant; Ed Carroll, minority counsel; Eileen Gunzelman, staff member; Kelsay Meek and Lesley Lehrkinder of Congressman Gonzalez' staff; and court reporters Ray A. Boyum and Marcia Stein.

Anything else from my colleagues?

If not, we are adjourned. Thanks to each of you.

[Whereupon, at 4 p.m., the subcommittee was adjourned.]

APPENDIX

Additional Material Submitted for Inclusion in the Record

[illegible]
[illegible]
[illegible], PENNSYLVANIA
[illegible], TENNESSEE
JAIME B. FUSTER, PUERTO RICO

Telephone (202) 225-2828

U.S. HOUSE OF REPRESENTATIVES
NINETY-NINTH CONGRESS
SUBCOMMITTEE ON GENERAL OVERSIGHT
AND INVESTIGATIONS
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
ROOM B-304 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515

[illegible]
[illegible]
[illegible], CALIFORNIA
STEVE BARTLETT, TEXAS
ROD CHANDLER, WASHINGTON
AL McCANDLESS, CALIFORNIA

September 30, 1985

Honorable Caspar W. Weinberger
Secretary of Defense
The Pentagon
Washington, DC 20301

Dear Mr. Secretary:

The Subcommittee on General Oversight and Investigations of the House Banking Committee plans to hold hearings on H.R. 3020, the "War Profiteering Prohibition Act of 1985," a bill to revise and reinstate the Renegotiation Act of 1951. I would like to offer you an opportunity to testify on this subject during the first day of hearings to be held on Thursday, October 24, 1985, at 10:00 a.m. in Room 2128 of the Rayburn House Office Building.

As you know, our General Oversight and Investigations Subcommittee (formerly the General Oversight and Renegotiation Subcommittee) has held oversight hearings on defense contracting and on legislation to reinstate the Renegotiation Board. The members of the Subcommittee and I look forward to receiving your testimony or that of your representative on October 24.

It would be appreciated if you would limit your verbal testimony to 10 minutes; any additional printed statement which you may wish to submit will be included in the hearing record in its entirety. Since we should receive printed testimony within 48 hours of your scheduled appearance, we request 100 copies by Tuesday, October 22 at Room B-304 Rayburn House Office Building.

Please let me know at your earliest convenience whether you will be able to appear before the Subcommittee. You may respond to the Subcommittee Counsel, Greg Carter, or Staff Director, Mary Martha Fortney.

With best wishes for you, I am

Sincerely yours,

Carroll Hubbard

CARROLL HUBBARD
Chairman
Subcommittee on General
Oversight and Investigations

CH/gmc/mnf

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[illegible] NEW YORK
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[illegible] TEXAS
[illegible] WASHINGTON
AL McCANDLESS CALIFORNIA

September 30, 1985

Honorable John O. Marsh, Jr.
Secretary of the Army
The Pentagon
Washington, DC 20310

Dear Mr. Secretary:

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CARROLL HUBBARD
Chairman
Subcommittee on General
Oversight and Investigations

CH/gmc/mmf

[illegible] TEXAS
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U.S. HOUSE OF REPRESENTATIVES
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OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
ROOM B-304 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515

September 30, 1985

Honorable Verne Orr
Secretary of the Air Force
The Pentagon
Washington, DC 20330

Dear Mr. Secretary:

The Subcommittee on General Oversight and Investigations of the House Banking Committee plans to hold hearings on H.R. 3020, the "War Profiteering Prohibition Act of 1985," a bill to revise and reinstate the Renegotiation Act of 1951. I would like to offer you an opportunity to testify on this subject during the first day of hearings to be held on Thursday, October 24, 1985, at 10:00 a.m. in Room 2128 of the Rayburn House Office Building.

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It would be appreciated if you would limit your verbal testimony to 10 minutes; any additional printed statement which you may wish to submit will be included in the hearing record in its entirety. Since we should receive printed testimony within 48 hours of your scheduled appearance, we request 100 copies by Tuesday, October 22 at Room B-304 Rayburn House Office Building.

Please let me know at your earliest convenience whether you will be able to appear before the Subcommittee. You may respond to the Subcommittee Counsel, Greg Carter, or Staff Director, Mary Martha Fortney.

With best wishes for you, I am

Sincerely yours,

Carroll Hubbard

CARROLL HUBBARD
Chairman
Subcommittee on General
Oversight and Investigations

CH/gmc/mmf

U.S. HOUSE OF REPRESENTATIVES
NINETY-NINTH CONGRESS
SUBCOMMITTEE ON GENERAL OVERSIGHT
AND INVESTIGATIONS
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
ROOM B-304 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515

September 30, 1985

Honorable John Lehman
Secretary of the Navy
The Pentagon
Washington, DC 20350

Dear Mr. Secretary:

The Subcommittee on General Oversight and Investigations of the House Banking Committee plans to hold hearings on H.R. 3020, the "War Profiteering Prohibition Act of 1985," a bill to revise and reinstate the Renegotiation Act of 1951. I would like to offer you an opportunity to testify on this subject during the first day of hearings to be held on Thursday, October 24, 1985, at 10:00 a.m. in Room 2128 of the Rayburn House Office Building.

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Sincerely yours,

Carroll Hubbard

CARROLL HUBBARD
Chairman
Subcommittee on General
Oversight and Investigations

CH/gmc/mmf

[illegible] PENNSYLVANIA
BART GORDON, TENNESSEE
JAIME B. FUSTER, PUERTO RICO

TELEPHONE (202) 225-2828

[illegible] NEW YORK
[illegible] CALIFORNIA
[illegible] TEXAS
[illegible] WASHINGTON
[illegible] CALIFORNIA

U.S. HOUSE OF REPRESENTATIVES
NINETY-NINTH CONGRESS
SUBCOMMITTEE ON GENERAL OVERSIGHT
AND INVESTIGATIONS
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
ROOM B-304 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515

September 30, 1985

Mr. Fred Newton
Acting Director
Defense Contract Audit Agency
Cameron Station, Building 4
Alexandria, VA 22314

Dear Mr. Newton:

The Subcommittee on General Oversight and Investigations of the House Banking Committee plans to hold hearings on H.R. 3020, the "War Profiteering Prohibition Act of 1985," a bill to revise and reinstate the Renegotiation Act of 1951. I would like to offer you an opportunity to testify on this subject during the first day of hearings to be held on Thursday, October 24, 1985, at 10:00 a.m. in Room 2128 of the Rayburn House Office Building.

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Sincerely yours,

Carroll Hubbard

CARROLL HUBBARD
Chairman
Subcommittee on General
Oversight and Investigations

CH/gmc/mmf

[illegible]
KAPTUR OHIO
[illegible]
PAUL E. KANJORSKI PENNSYLVANIA
[illegible] TENNESSEE
JAIME B. FUSTER PUERTO RICO

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WASHINGTON, DC 20515

[illegible]

September 30, 1985

Honorable Charles A. Bowsher
Comptroller General of the United States
General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Bowsher:

The Subcommittee on General Oversight and Investigations of the House Banking Committee plans to hold hearings on H.R. 3020, the "War Profiteering Prohibition Act of 1985," a bill to revise and reinstate the Renegotiation Act of 1951. I would like to offer you an opportunity to testify on this subject during the first day of hearings to be held on Thursday, October 24, 1985, at 10:00 a.m. in Room 2128 of the Rayburn House Office Building.

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With best wishes for you, I am

Sincerely yours,

Carroll Hubbard

CARROLL HUBBARD
Chairman
Subcommittee on General
Oversight and Investigations

CH/gmc/mmf

WORTLEY NEW YORK
DREIER CALIFORNIA
BARTLETT TEXAS
CHANDLER WASHINGTON
ANDLESS CALIFORNIA

U.S. HOUSE OF REPRESENTATIVES
Ninety-Ninth Congress
SUBCOMMITTEE ON GENERAL OVERSIGHT
AND INVESTIGATIONS
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
ROOM B-304 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515

COPY

October 15, 1985

Mr. William R. Tolley, Director
Legislative Affairs
Harris Corporation
1025 West Nasa Boulevard
Melbourne, FL 32919

Dear Bill:

The Subcommittee on General Oversight and Investigations of the House Banking Committee plans to hold hearings on H.R. 3020, the "War Profiteering Prohibition Act of 1985," a bill to revise and reinstate the Renegotiation Act of 1951. I would like to offer you an opportunity to testify on this subject during the second day of hearings to be held on Wednesday, October 30, 1985, at 10:00 a.m. in Room 2128 of the Rayburn House Office Building.

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With best wishes for you, I am

Sincerely yours,
Carroll Hubbard

Carroll Hubbard
Member of Congress

CH/gmc/mmf

Bill —

P.S. I am delighted that you have accepted the invitation, Bill.
Look forward to seeing you on October 30. CH.

[illegible]
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[illegible]
ROBERT GARCIA, NEW YORK
MARCY KAPTUR, OHIO
GERALD D. KLECZKA, WISCONSIN
PAUL E. KANJORSKI, PENNSYLVANIA
BART GORDON, TENNESSEE
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STAN PARRIS, VIRGINIA
GEORGE C. WORTLEY, NEW YORK
DAVID DREIER, CALIFORNIA
STEVE BARTLETT, TEXAS
ROD CHANDLER, WASHINGTON
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ROOM B-304 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
September 30, 1985

Mr. Richard G. Mulligan, Chairman
Committee on Government Business
Vice President, Finance and Control of TRW
Financial Executives Institute
1050 17th Street, NW, Suite 520
Washington, DC 20036

Dear Mr. Mulligan:

The Subcommittee on General Oversight and Investigations of the House Banking Committee plans to hold hearings on H.R. 3020, the "War Profiteering Prohibition Act of 1985," a bill to revise and reinstate the Renegotiation Act of 1951. I would like to offer you an opportunity to testify on this subject during the second day of hearings to be held on Wednesday, October 30, 1985, at 10:00 a.m. in Room 2128 of the Rayburn House Office Building.

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Sincerely yours,

Carroll Hubbard

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Chairman
Subcommittee on General
Oversight and Investigations

CH/gmc/mmf

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STEVE BARTLETT, TEXAS
ROD CHANDLER, WASHINGTON
AL McCANDLESS, CALIFORNIA

September 30, 1985

Mr. Donald S. Grenough
Partner
Touche Ross & Company
1900 M Street, NW, Suite 300
Washington, DC 20036

Dear Mr. Grenough:

The Subcommittee on General Oversight and Investigations of the House Banking Committee plans to hold hearings on H.R. 3020, the "War Profiteering Prohibition Act of 1985," a bill to revise and reinstate the Renegotiation Act of 1951. I would like to offer you an opportunity to testify on this subject during the second day of hearings to be held on Wednesday, October 30, 1985, at 10:00 a.m. in Room 2128 of the Rayburn House Office Building.

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With best wishes for you, I am

Sincerely yours,

Carroll Hubbard

CARROLL HUBBARD
Chairman
Subcommittee on General
Oversight and Investigations

CH/gmc/mmf

094861 PSAD-77-165

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

SEP 10 1977

The Honorable William Proxmire
Chairman, Committee on Banking,
  Housing and Urban Affairs
United States Senate

Dear Mr. Chairman:

In accordance with your letters dated June 9, 1977, and July 21, 1977, we have reviewed the costs of compliance with the Renegotiation Act of 1951, as amended (50 U.S.C. App. 1211 et. seq.), claimed to have been incurred by selected contractors, as well as studies by the Renegotiation Board and two industry associations. As requested, our work was conducted at the following activities: Hewlett-Packard Company; FMC Corporation; Teledyne, Incorporated; Eaton Corporation; Cutler-Hammer, Incorporated; Fairchild Industries; John Fluke Manufacturing Company; Barnes Engineering Company; Financial Executives Institute; and the Renegotiation Board. In addition, we visited the Aerospace Industries Association of America to review their survey of compliance costs, and the firms of Astrosystems; Hopeman Brothers, Incorporated; and Martin Marietta Corporation, in connection with our evaluation of the Board's study.

Our specific objective was to ascertain if, as claimed by contractors, there were substantial costs incurred for complying with the requirements of the Renegotiation Act. We also evaluated studies prepared by the Renegotiation Board and industry associations attempting to determine the extent of such costs.

In general, we have concluded that some costs are necessarily incurred by contractors to comply with Renegotiation Act requirements. We are unable, however, to determine the magnitude of such costs or to what extent they are incremental to other financial data costs. The primary problem in determining and verifying such costs was that the contractors' accounting systems are not designed to identify and segregate such data.

It is important to note that because of unusual aspects of the firms covered in this review, any conclusions drawn from the data are unlikely to be representative of the approximately 3,000 firms that file with the Board. To illustrate: One contractor, Hewlett-Packard, claims and obtains exemptions for about 75 percent of its otherwise renegotiable sales. Under

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the Act, contractors can claim exemptions for standard commercial articles, standard commercial classes, and new durable productive equipment for otherwise renegotiable sales to the Government. This contractor accounts for 8 percent of all exemptions granted to all firms. The large amount claimed is costly to document. Also, seven of the eight contractors in our sample were assigned by the Board for field review. This process is also more costly than a simple filing since a field review requires the submission of substantial, additional data. The high representation of contractors reviewed in the field is unusual since only about 20 percent of companies filing fall into this category.

Our major observations are summarized below. Detailed reports of the results of our work at each of the locations we visited or contacted are included in enclosures 1 and 2.

THE NATURE OF INDUSTRY EFFORT TO COMPLY WITH THE RENEGOTIATION ACT

Complying with the requirements of the Renegotiation Act requires continuing effort on the part of Government contractors. All the companies reviewed perform some or all of the various tasks during the year relating to: identifying renegotiable sales; preparing and filing applicable reports; responding to Board requests for additional data if assigned for field review; and, in some cases, protesting a Board determination of excessive profits.

For the most part, these efforts involve a number of contractor employees at many corporate levels who spend a small amount of time on renegotiation matters. If the Renegotiation Act was repealed, in most cases only a few positions would be eliminated. In this situation, companies presumably would find alternative work for employees relieved of renegotiation tasks.

AN EVALUATION OF THE COSTS OF COMPLIANCE OF SELECTED CONTRACTORS

Contractor costs of compliance were mainly estimates that, in most cases, were backed up where feasible with various types of supporting data. The range of these cost estimates was $16,600 to $1.7 million annually. (See page 1 of enclosure 1.) Generally, we were only able to verify the accuracy of a part of the cost figures submitted. The corporate accounting systems we reviewed did not provide for the identification of costs of renegotiation functions. Estimates were based largely on employee recollection; and, in some instances, little or no records were maintained.

Regardless of how meticulous each contractor was in preparing its estimate of costs incurred in complying with renegotiation, none of the costs was recorded on a daily basis by the person or persons involved in the activity. Generally, it was necessary for the employees or their supervisors to estimate the amounts of time many months after the time was expended. In such instances, while we could verify salaries and associated costs, we were often unable to find any verifiable, objective evidence to support the time spent. Generally, a relatively minor part of the costs claimed to have been incurred by contractors represented the costs incurred to obtain professional assistance of experts and consultants outside the contracting organization. These were verified by us to actual billings and confirmation with suppliers where feasible.

Much of the cost of compliance estimate of the AIL Division of Cutler Hammer, Inc., and the Eaton Corporation appeared fairly reasonable, except that we could not verify various time estimates of employees engaged in renegotiation activities. We also had this problem in reviewing the Hewlett-Packard Company's cost estimate as discussed on p. 6.

The FMC Corporation did not maintain records or provide sufficient details on the composition of its estimate of the cost associated with renegotiation matters to enable us to evaluate its estimate. Two other companies could not provide us with their costs of compliance. An officer of Teledyne, Inc., advised that his estimate used in recent Senate Banking, Housing and Urban Affairs Committee hearings was based on personal experience, intuition, and discussions with members of the Financial Executives Institute. Estimates of the cost of compliance were not available at Fairchild Industries and could not be prepared within the time frame of our review.

In two instances, cost estimates were overstated. The companies involved were Barnes Engineering Company and John Fluke Manufacturing Company. Barnes' overstatement was for costs incurred for resubmitting and redoing information previously submitted to the Board. After our review of the filing instructions and consultation with the Board, we determined that Barnes did not have to submit this information.

In the case of Fluke Manufacturing Company, in the process of verifying the cost estimate, we found that certain key elements were unrealistically high.

Industry associations such as the Financial Executives Institute and the Aerospace Industries Association of America, Inc., declined, as a matter of policy, to identify participating companies involved in their cost of compliance surveys or to provide any details related to individual participants. Therefore, we were unable to evaluate their estimate of the cost of complying with the Renegotiation Act.

Are costs of compliance proportional to volume of sales?

Based on the estimates of compliance costs prepared by contractors, it would appear costs are not proportional to renegotiable sales. Costs can increase or decrease depending on:

1. The size of individual contractors or subcontractors.
2. The number of segments, e.g., cost centers, profit centers, plants or divisions receiving renegotiable business.
3. The amount of exemptions from renegotiation that is claimed and needs to be documented.
4. Whether a contractor's filing is (a) cleared without field review, (b) reviewed in the field but later determined not to have made excessive profits, or (c) reviewed in the field and determined to have made excessive profits. Field review generally requires additional schedules and further breakdowns of the data in the contractor's filing. A finding of excessive profit frequently entails additional paperwork plus the engagement of outside legal and accounting assistance.
5. The extent to which the contractor makes use of automated data processing in its recordkeeping activities.

AN EVALUATION OF WHAT THE RENEGOTIATION BOARD SAID IT IS COSTING INDUSTRY TO COMPLY

An analysis of the cost of filing was prepared by the Renegotiation Board in March 1977 for the Office of Management and Budget. This study estimated that the average contractor cost to file was about $3,300. We were informed by the Board that its estimated cost represents the cost per individual filing. When a company with a divisional corporate structure files a report, the Board counts this as a single filing. But when a company that has subsidiaries files an RB-1 report, each subsidiary must also file a report. These filings are counted as separate filings by the Board. The indicated cost estimates by the Board for the three firms in its analysis are just for the parent companies and do not include the filing cost for any subsidiaries. For example, we were told that the Board's estimate of $325 for Hopeman Brothers does not represent the filing costs of its four subsidiaries. When those subsidiaries are considered, the total filing costs for Hopeman Brothers in the Board's analysis should be $845. We have evaluated the analysis and present the following observations.

The Renegotiation Board developed the estimate of contractor costs of compliance by selecting three contractors that it believed were representative of the small, medium, and large contractors performing renegotiable business. None of the contractors was made aware of the fact that it was included in the study and none was asked by the Board what it estimated its individual costs of compliance to be. The estimate of contractor costs was made solely on the knowledge casually picked up by Renegotiation Board personnel during their prior contacts with respect to the contractor's filing. Some consideration was given to whether a contractor was assigned for field review or cleared without assignment and the probable volume of contractors falling into each size category.

We do not believe, and the Renegotiation Board agrees, that a sample of three contractors out of approximately 3,000 annual filings is a representative sample of the population.

There are indications that the amount of costs ascribed to the small and medium contractors is understated because it does not contain provision for all the types of costs that contractors claim to incur to comply with the Renegotiation Act. For the most part, the Board's analysis appeared to limit the costs to those incurred for personnel directly involved in preparing the basic filing document, RB-1 (Standard Form of Contractor's Report). We believe it is reasonable to assume that some cost is incurred, for example: in identifying sales as renegotiable or nonrenegotiable; contacting customers if purchase documents are unclear with respect to renegotiation; recording such sales and related costs; and building up schedules and data to support exemptions if taken. We saw no indication that such costs were provided for in the Board's estimates.

We also noted that the Board assumed that 80 percent of each category of contractors would be cleared without assignment and 20 percent would be assigned to its field offices for more detailed examination. While the 80/20 distribution may be accurate with respect to all filings, it is not necessarily accurate for each category. We brought this to the Board's attention during our review and Board personnel provided the actual distribution in each category for FY 1976. They also informed us that the more accurate distribution was not available to them at the time they prepared their study. Utilizing the same Renegotiation Board estimates of contractor costs, this change in distribution caused the weighted average estimate of contractor cost to decrease to $1,880.

In addition, the Board informed us that its estimates of cost of compliance are a cost per filing rather than the total cost per contractor when more than one filing is required because the contractor has subsidiaries with renegotiable sales.

We made available to a Renegotiation Board member a copy of the sections of this report dealing with the Board's analysis. His comments were considered in the report.

Hewlett-Packard Company

During recent Senate Banking, Housing and Urban Affairs Committee hearings on the Renegotion Reform Act of 1977, the Hewlett-Packard Company chairman, in testimony, presented various estimates on what it costs his company yearly to comply with the Renegotiation Act. In subsequent testimony, the Chairman of the Renegotiation Board questioned these figures and charged that the compliance cost claimed by the company was erroneous.

As requested, we reviewed the cost of compliance estimates at the Hewlett-Packard Company. We conclude that

--the company's approach to developing the estimate appeared reasonable;

--there was a substantial amount of supporting detail for the estimate; and

--while we were unable to validate the costs claimed because of time and documentation limitations, we found the company does expend considerable effort and costs in filing with the Board.

During the hearings, the Chairman of the Renegotiation Board also argued that the information supplied to the Board by Hewlett-Packard Company is the same as information accumulated for compliance with the Truth-in-Negotiation Act (Public Law 87-653), and that there is no additional cost of complying with the Renegotiation Act. We found, however, that the provisions and requirements of the Renegotiation Act are significantly different from those of other laws, such as the Truth-in-Negotiations Act, and that separate procedures are needed in order to satisfy the requirements of the Renegotiation Act.

We gave each of the contractors we reviewed a summary of our findings. Informal or written comments were received and considered in developing this report. Copies of all written comments are included in enclosure 1. In most cases, the contractors agreed with the facts presented. Hewlett-Packard, however, was disappointed that we could not state an opinion as to the reasonableness of its costs.

We trust the above information and enclosures are responsive to your needs. If we can be of further assistance, please let us know.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

Enclosures

RESULTS OF REVIEW OF INDIVIDUAL COMPANY AND INDUSTRY ASSOCIATION ESTIMATES OF THE COSTS OF COMPLIANCE WITH THE RENEGOTIATION ACT

CONTENTS

Page

SUMMARY SCHEDULE OF CONTRACTORS REVIEWED 1

BARNES ENGINEERING COMPANY 2

CUTLER-HAMMER, INC. 6
  CONTRACTOR COMMENTS 18

EATON CORPORATION 20
  CONTRACTOR COMMENTS 25

FAIRCEILD INDUSTRIES, INCORPORATED 27

JOHN FLUKE MANUFACTURING COMPANY 28

FMC CORPORATION 40
  CONTRACTOR COMMENTS 54

HEWLETT-PACKARD COMPANY 56
  CONTRACTOR COMMENTS 73

TELEDYNE, INC. 76

AEROSPACE INDUSTRIES ASSOCIATION
  OF AMERICA, INC. 77

SUMMARY SCHEDULE OF CONTRACTORS REVIEWED

Firm	Sales for fiscal year	Total sales (in millions)	Amount of renegotiable sales (in millions)	Does firm claim any exemptions?	Was the firm recently assigned?	Firms' estimated cost of compliance: Annual filing of RD-1 and support documents	Firms' estimated cost of compliance: Additional cost when assigned for a field review
Barnes Eng. Co.	1976	$ 10.6	$ 7.2	No	No	a/$ 16,600	Not applicable
Cutler-Hammer, Inc.	1975	318.7	95.5	No	Yes	23,360	$ 58,019
Eaton Corp.	1975	1,558.3	4.1	b/Yes	Yes	16,465	1,755
Fairchild Industries	1975	193	124	No	Yes	Data not available	
John Fluke Mfg. Co.	1976	49.2	9.3	f/Yes	Yes	g/37,112	h/4,275
Teledyne, Inc.	1975	1,551	408	No	Yes	Data not available	
FMC Corp.	1975	2,020	106	Yes	Yes	923,400 to	c/e/1,715,000
Hewlett-Packard Co.	1975	981.2	126	d/Yes	Yes	198,000 to	e/247,000

a/Estimate overstated by a substantial part of a $3,800 cost element (see pages 4 and 5, enclosure 1).

b/$460,000 claimed in exemptions.

c/Due to limitations on our work, we could not verify the accuracy or reasonableness of any of FMC's cost estimates.

d/$97 million are claimed in exemptions.

e/These costs are for both filing the RD-1 and supplying additional information regarding an assignment.

f/$4.5 million claimed under standard commercial article exemption.

g/Estimate overstated by $19,733 based on our review. At the conclusion of our review, Fluke provided us with revised estimate of $20,506.

h/Estimate overstated by $1,400.

BARNES ENGINEERING COMPANY

BACKGROUND

Barnes Engineering Company designs, develops, and produces infrared and electro-optical systems, instruments and components for use in space exploration, defense, research, industry and the natural sciences. Products include detectors, optical alignment instruments, remote sensing instruments, analytical accessories, and medical, military and space instrumentation. The company is headquartered in Stamford, Connecticut, with plants in Stamford and Waltham, Massachusetts.

The company had sales revenues of approximately $10 to $13 million per year during the last 5 fiscal years. Fiscal year 1976 sales were $10.6 million. It has not applied for or taken any exemptions during this time. Its past reports to the Renegotiation Board have never been assigned to a regional board for field review. According to company officials, approximately 30 percent of yearly sales are entirely commercial and not subject to renegotiation. The remaining 70 percent represents both prime and subcontract government sales. Of the $7,201,891 renegotiable sales reported in FY 1976, $5,181,653 represented subcontracts.

COST OF COMPLIANCE

Barnes estimates it cost approximately $16,600 to comply with the filing requirements of the Board for FY 1976. Company officials maintain this figure is representative of a yearly cost. The cost estimate is based on the judgment of the financial vice president. Estimates of the time spent on compliance were developed by the individuals involved and costed out on a direct compensation basis with no overhead considerations. Because they are estimates, we were unable to trace these costs to company financial records. Following is a breakout of Barnes' estimated annual cost of compliance.

Cost elements	Annual cost
Legal	$ 2,000
Marketing	1,000
Accounting	750
Financial	1,550
EDP	4,500
Report Preparation	3,000
Miscellaneous	3,800
Total	$16,600

Legal Cost--Cost estimated for review of reports, regulations and contracts by the company's attorney with some outside consultation The estimate is 4 percent of the company's annual legal costs based on the estimated percent of time spent on renegotiation matters by the company's in-house attorney. Barnes contends it would not incur these costs, with the exception of the legal review of all government contracts, if there were no compliance requirements.

Marketing Cost--Cost estimated for transferring information on orders that appear to be commercial, but later are determined to be subject to renegotiation. This estimate represents 3 hours per week for retyping and reprocessing. This cost would not be incurred if there were no reporting requirements.

Accounting Cost--Cost estimated for public accounting review of information contained in reports to the Board. Cost is based on 1-1/2 days of time charges. This cost, according to the company, would not be incurred if there were no reporting requirements.

Financial Cost--Cost estimated for maintenance of regulation data and review of data and reports by the financial vice president. The basis of this estimate is 2 weeks per year of his time. Much of this cost would still be incurred because the review of regulations and reports pertain to other agencies in addition to the Board.

EDP Cost--Cost estimated for processing and reprocessing information for compliance. The estimate is 3 percent of total EDP costs, based on 1-1/2 weeks per year per person, or 3 percent of the person's total annual time. Barnes maintains most of these costs would not be incurred if there were no compliance requirements.

Report Preparation--Cost estimated for development of data, regulation review, and report preparation by the comptroller. The estimate is based on 1-1/2 months of the comptroller's time. Much of this cost would be incurred if there were no compliance requirements because the time spent was also in conjunction with in-house and other Federal reports.

Miscellaneous Cost--Cost estimated for resubmitting and redoing information previously submitted to the Board. The majority of this estimate for FY 1976 is for submitting information to support a Statement of Non-Applicability. After a review of the filing instructions and consultation with the Board, we determined that Barnes did not have to submit this statement or its support. We brorght this matter to Barnes' attention and were told this will materially reduce the estimate for this category of costs.

Summary

The cost of compliance developed by Barnes is an estimate. The figure of $16,600 is overstated by a substantial part of the $3,800 estimate for miscellaneous expenses. Only a portion of the remainder of Barnes' estimated costs would be incurred if there were no filing requirements. However, we were unable to determine what portion of those estimates could be considered incremental.

CUTLER-HAMMER, INC.

BACKGROUND

Cutler-Hammer, Inc. (C-H) is a diversified international electronics company headquartered in Milwaukee, Wisconsin. It designs and produces electrical/electronic equipment and aerospace systems and subsystems for industry, commerce, and Government. It has 30 production and/or research facilities in the United States and 17 plants in 13 other countries.

From 1972 through 1975, C-H reported to the Renegotiation Board sales that averaged about $290.5 million annually--of which about $93.4 million or 32.1 percent was reported as renegotiable sales. Its AIL Division in New York was responsible for about $84.1 million or 90 percent, of the renegotiable sales. We visited the AIL Division and prepared a separate summary of its estimated cost of compliance with the Renegotiation Act. (See p.13). C-H companywide and AIL Division sales for fiscal years 1972 through 1975 are shown below:

	C-H companywide sales			AIL Division sales			
Year ended Dec. 31	Total	Renegotiable	Percent renegotiable	Total	Renegotiable	Percent renegotiable	Percent c companywide renegotiable
	(Millions)			(Millions)			
1972	$249.1	$86.4	34.7	$ 89.4	$79.5	88.9	92.0
1973	282.1	94.1	33.4	97.2	87.1	89.6	92.6
1974	312.2	97.5	31.2	103.1	88.9	86.2	91.2
1975	318.7	95.5	30.0	104.6	80.9	77.3	84.7
Avg.	$290.5	$93.4	32.1	$ 98.6	$84.1	85.3	90.0

The Renegotiation Act permits certain exemptions from renegotiation. C-H, however, does not claim any exemptions. C-H's Controller told us that since C-H has never been in danger of having to make any refund, it is not worth the time and cost to substantiate any exemptions.

SCOPE

We traced elements of the Cutler-Hammer, Inc., cost estimates to source documents (invoices, expense vouchers, etc.) whenever available. For estimates based on employee recollections of time spent on various activities, we interviewed knowledgeable personnel and, to the extent practical, identified the work produced. We also discussed the cost estimates and proposed renegotiation legislation with C-H officials.

Cost estimates prepared by C-H's AIL Division, New York, which generates about 90 percent of C-H's renegotiable business were separately reviewed.

PROCESSING AND REPORTING RENEGOTIATION DATA

The number of Standard Form of Contractor's Report for Renegotiation (RB Form 1) C-H files differs from year to year depending on the organizational composition of C-H, its divisions and subsidiaries. In 1975, for example, C-H prepared nine reports--an overall consolidated report for C-H, Inc., and its subsidiaries; three reports covering C-H, Inc., and each of its two divisions; and five reports covering each of five subsidiary companies.

According to information provided by C-E, processing data for renegotiation reports is time consuming and requires professional skills. The information for the report and schedules is drawn from 17 separate accounting systems. The accounting and financial management systems are designed to produce data in a form useful for managing C-E's business, not to report renegotiation data. Furthermore, none of the systems, including those maintained by the various divisions and subsidiaries, include all of the information necessary for preparing renegotiation reports. As a result, renegotiation data must be abstracted from the system, analyzed, and reclassified by professional accountants.

Developing data for renegotiation starts with coding of sales orders and sales entries relating to renegotiation. If the nature of the sale is not obvious, sales personnel ask the customer if the sale is renegotiable. Some of the coded sales data is stored in the C-E automatic data system and an itemized list of the sales is run to prepare the renegotiation report. Other renegotiation sales data is obtained from each division.

A C-E corporate tax service accountant analyzes sales and cost data and prepares the renegotiation report. The accountant uses Federal income tax worksheets to determine total sales and costs. He determines a portion of renegotiable sales from the listing prepared by the C-E automatic data processing unit and data provided by the various divisions. Renegotiable costs and other income are determined by analysis of the income tax worksheet or by proration in the proportion of renegotiable sales to non-renegotiable sales or some similar method.

The Controller told us that renegotiation comprises a small portion of the duties of personnel involved in the renegotiation process. Thus, he said it is unlikely that C-E would dismiss the individuals if renegotiation were eliminated. Nevertheless, he said that the elimination would result in real savings to C-E. He stated further that somewhere down the line a reduction in work requirements must result in reduced personnel or, the personnel would be shifted to other duties more beneficial to the company. Subsequently, in commenting on our report, the Controller of C-E stated that the staff at both AIL and headquarters would be reduced if renegotiation were not in effect, and that the company estimates a reduction of two professional staff members with a related cost saving of about $36,000 annually.

COST OF RENEGOTIATION

The C-E accounting system does not identify the cost of compliance with renegotiation requirements. Therefore, C-E had to estimate the costs involved. C-E estimated its cost of renegotiation to be $81,379--$66,056 for the AIL Division and $15,323 for C-E headquarters. The headquarters' estimated costs include $4,860 for preparing required annual renegotiation reports and $10,463 for complying with Renegotiation Board requests for information regarding the assigned year, 1972.

The $4,860 estimated cost of preparing required annual reports is a recurring cost. The $10,463 estimate for complying with Board requests, however, may vary from year to year.

C-B officials stated that their cost estimate is a little low. For example, fringe benefits of 25 percent of wages are based on companywide rates; however, fringe benefits for headquarters personnel are higher--possibly as much as 30 percent of wages. Also, the costs do not include nonpersonnel costs and other incidental costs which could be associated with renegotiation.

C-B officials also told us that the Board's requests regarding the FY 1972 reports were so complex that C-B had to hire a consultant at fees of about $30,000 to assist them in responding. Other costs have been incurred to prepare the responses and for travel and consultation. The Board has requested information of similar complexity regarding C-B's FY 1973 reports. C-B has also been assigned for fiscal 1974, but has not received any requests for additional information. C-B has not yet been assigned for fiscal 1975. C-B officials said other costs may decrease since there is a learning process involved and the consultant may not be needed as extensively. They could not, however, predict what the costs would be.

Details of the C-B estimate of its headquarters cost are shown below:

Annual cost of preparing renegotiation reports	
Coding, clerical, and computer costs	$ 1,020
Worksheet and report preparation	2,625
Consultation and review	1,215
Total	$ 4,860

Cost of compliance--assigned year 1972	
Responses to Renegotiation Board accounting agenda (requests for information)	$ 6,825
Coordinating information--meetings with AIL	
Division (includes travel and per diem expenses)	3,090
Consultation (outside consultant)	548
Total	$10,463
Total cost of compliance	$15,323

The estimated costs for the various functions--except travel and per diem costs and consultant fees--were based on employees' estimates of the number of days spent on the functions. The estimated days were multiplied by the daily pay rates and average fringe benefits paid companywide. We determined the basis for the pay rate and fringe benefits and found them to be reasonably accurate. We could not verify the time estimates.

Each of the cost estimate elements is described below:

Coding, clerical, and computer costs - $1,020

This cost consists of $900 for 12 days (at $75 a day), which five C-B locations estimated were required to code and accumulate renegotiable data, and $120 for the C-B automatic data processing unit to prepare a listing of renegotiable sales orders.

Worksheet and report preparation - $2,625

This cost was supported by a detailed estimate of the time required for a C-B corporate tax service accountant to prepare worksheets, supporting schedules and the renegotiation reports--35 days at $75 a day.

Consultation and review - $1,215

This function includes $375 for the corporate tax service accountant (5 days at $75 per day); $600 for the corporate tax service manager (5 days at $120 per day); and $240 for the C-E Controller (1 day at $240 per day).

Responses to Renegotiation Board agenda - $6,825

Costs include $825 for 11 days work performed by an accountant and locations other than headquarters; $3,600 for 30 days by the tax service manager; and $2,400 for 10 days by the Controller.

Coordinating information - $3,090

Costs were traced to travel vouchers submitted by the Controller and corporate tax service manager.

Consultation - $548

Costs were traced to bills submitted by an outside consultant. The bills did not show the subject of consultation; the controller stated that the firm is retained solely for advice on renegotiation. The Controller also stated that the AIL Division paid the consultant $29,556.

CONCLUSIONS

Because the C-E estimate of headquarters compliance cost was based largely on employee recollection, we could not verify its accuracy. It was evident that preparation of the renegotiation reports and responses to Renegotiation Board requests required considerable professional accounting skills.

AIL DIVISION

BACKGROUND

AIL is a division of Cutler-Hammer, Inc. (C-H) AIL's renegotiable business constitutes the bulk of Cutler-Hammer's total renegotiable business. The company files an RB Form 1 (Standard Form of Contractor's Report for Renegotiation) on an overall basis, and also files an RB-1 for its AIL Division. We were advised that renegotiation compliance costs are incurred at the AIL Division level and also at the C-H corporate level.

SCOPE

Our review at the AIL Division included discussion of the contractor's support and rationale for the cost data prepared, review of the procedures for preparing the annual renegotiation report (RB-1 form), and a test of data in support of the costs.

COSTS OF COMPLIANCE

AIL's costs to comply with the renegotiation requirements were estimated at about $66,000 yearly. This consists of about $18,500 incurred in preparing the RB-1 report and an additional $47,556 resulting from the Board's assignment process.

C-H's annual report shows that its renegotiation matters were settled for 1971 and prior years without any determination of excessive profit. The contractor's representatives said that in March 1974, the firm's 1972 results were assigned by the Board. According to these representatives the contractor has not been notified of the Board's determination and, indeed, the Board has not completed its review. Thus, the costs attributed to the assignment process may increase before completion.

AIL's estimated costs of compliance are set out in a schedule below. The costs shown are related only to those costs incurred in the preparation of data at the AIL level. As discussed previously, additional costs are incurred at C-B's corporate level in connection with AIL's RB-1.

AIL Division, Cutler-Hammer, Inc.

Annual costs for complying with renegotiation requirements

Preparation of RB-1 report	Amount
Analysis of contract terms, renegotiability, preparation of data for entry into accounting system	$ 2,000
Review of year-end results, analysis and summary of data to compile RB-1 report, review, validation of initially prepared data	5,000
Development of RB-1 data for three other AIL subsidiary companies/divisions	6,500
Consolidation of total AIL results, intercompany eliminations	4,000
Final management review and submission to Cutler-Hammer	1,000
Total	$18,500

Cost of Board's assignment	Amount
Preparation of schedule of major (over $100,000) renegotiable contracts	$ 4,000
Development and preparation of data in response to Board's inquiries and accounting agenda	9,000
Meetings and coordination with Cutler-Hammer headquarters	3,000
Training of personnel--attendance at seminars	1,000
Consultant's costs	29,556
Briefings and top management reviews--AIL Division	1,000
Total	$47,556
Grand Total	$66,056

We noted that AIL's RB-1 report was supported by a file of worksheets and supporting materials. We also observed a mass of material, supporting worksheets and data which was prepared in response to the Board's assignment of the 1972 results. Our observation of these materials and discussions with contractor representatives indicate that substantial effort was involved in complying with the renegotiation requirements.

We were informed that the employees who are involved in the renegotiation process spend only part of their time on these tasks during the year. To this extent they are relieved of other duties. If the Renegotiation Act expired, duties would be rearranged and one position might be eliminated in this division.

USE OF OTHER DATA FOR RENEGOTIATION REPORTING PURPOSES

We were advised that other existing government contract reporting requirements cannot be used, as such, to prepare all required renegotiation information. For example, all contracts received by AIL were not rated under the Defense Production Act priority rating system. Therefore, it is necessary to make further inquiries on the renegotiability status of the order. In addition, the RB-1 Form requires the data to be tied into the firm's financial statements and Federal income tax return. These data include information not generated for government contract purposes.

CONCLUSIONS

Based on our review we believe that:

--The contractor's estimated costs represent incremental costs applicable to the renegotiation requirements. We did not note any costs which were truly discretionary and not required as a result of the renegotiation requirements.

--The costs generally were documented and supported and represent a realistic evaluation of the costs incurred except that the costs of personnel time spent on renegotiation matters were not susceptible to audit verification.

CUTLER • HAMMER

MILWAUKEE, WISCONSIN

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August 29, 1977

Mr. Sidney Wolin
Assistant Director PSAD/GP
U.S. General Accounting Office
441 G Street N.W., Room 6073
Washington, D.C. 20548

Dear Mr. Wolin:

The General Accounting Office, at the request of Senator Proxmire, has recently reviewed Cutler-Hammer's estimated cost of compliance with the Renegotiation Act of 1951. The reviews were conducted in two locations; the AIL Division located in Deer Park, New York, and the Headquarters Office in Milwaukee, Wisconsin. Two separate reports were submitted to you covering these locations, which show the compliance cost of Cutler-Hammer, Inc. to be as follows:

Headquarters Office (From Chicago Region Office Report)	$15,323
AIL Division (From New York Regional Office Report)	66,056
	$81,379

The cost includes $23,360 associated with the preparation of the annual RB-1 Report and $58,019 relating to requests for additional detailed information as a result of the Board's review of the RB-1 Report for 1972. This is the earliest open year currently in process and final resolution has not yet been received from the Board. Additional information may be requested and additional costs incurred before finalization.

We would like to make the following additional comments regarding the reports.

We do not maintain time records with respect to the professional staff that prepares the Renegotiation Report. As a result, the time estimates provided Government representatives were based on studies made by knowledgeable individuals involved in the various aspects of the report preparation. At both the AIL Division and the Headquarters Office, the work papers and files were reviewed and discussed with the examiners. The Company believes that the Government representatives, after reviewing the detailed effort required to comply with requests for information from the Renegotiation Board including the preparation of the recently revised RB-1 Form, were satisfied as to the reasonableness of the estimates resulting from the studies.

The reports also touch on the possible cost savings that would result if the Company did not have to go through the Renegotiation exercise. While it is difficult to be specific in this area, there is no doubt that if the Renegotiation Report were not required, the staff at both AIL and Headquarters would be reduced. Any reduction in work load ultimately has an impinging effect on the number of people required to perform necessary functions. Our best estimate at this point would be a staff reduction of two persons at the bottom of the professional scale as the various time savings kaleidoscoped into a need for fewer staff members. At an estimated cost of $18,000 per staff person (including fringe benefits), this would represent a cost saving of about $36,000 annually.

With respect to the standard commercial article exemption, Cutler-Hammer, Inc. does not claim this exemption because the additional effort required to substantiate the exemptions would be uneconomical. The Company's posture with respect to renegotiation has had no bearing on this decision.

The Federal Income Tax papers do not provide the detail necessary for the Renegotiation Report. They are used to extract detailed information concerning other income, other deductions and book to tax reconciling items in order to allocate these items to renegotiable and non-renegotiable business, since the Renegotiation Report must be prepared on a tax basis. Renegotiable sales and costs must be obtained from the records generated by the accounting systems of the Company.

With respect to the possibility of using a completed contract method of accounting for renegotiation purposes, we indicated that we could not know what problems would be created until rules and regulations as to implementation would be issued. We feel that the completed contract method could create serious cutoff problems with respect to both sales and costs, particularly in the area of amendments and additions to contracts. Of particular concern would be the handling of items normally considered period costs such as G and A expenses. Each contract would have to bear its fair share of such costs for its entire existence as opposed to only a share for the year of completion. Much more information would be needed in this area before the Company could adequately respond regarding its ability to meet the requirements of this type of reporting.

We wish to express our appreciation for the opportunity to review and to comment on the reports. We will be pleased to furnish additional information should further clarification be required.

Very truly yours,

CUTLER-HAMMER, INC.

M. J. Saunders

M. J. Saunders
Controller

MJS/bjh

CC: Mr. A. L. Panico
Mr. J. Sobota

EATON CORPORATION

BACKGROUND

Eaton Corporation, Cleveland, Ohio, is a large diversified manufacturing concern composed of 74 divisions. Its major products are truck and off-highway vehicle components, automotive components, industrial vehicles, construction and woodland vehicles, industrial power transmission systems and components, and security products and systems. Net sales for the fiscal year ended December 31, 1975, were $1.6 billion. Total fiscal 1975 sales subject to the Renegotiation Act were $4.6 million—10 percent exemptions were claimed on these sales. Such sales were attributable to 21 divisions.

Eaton has few direct sales to the Government. Its products are primarily purchased by other manufacturers who use them as components in their products. Some of these products are sold to the Government resulting in an indirect Government sale by Eaton. The Eaton products involved in these indirect sales and those sold commercially are essentially the same.

PROCEDURES FOR COMPLIANCE

Because renegotiable sales are primarily indirect in nature, and not available within their record system, Eaton has chosen to canvas its customers annually to determine the amount of renegotiable sales. Each year Eaton's domestic divisions review their sales records to determine which customers should be sent form letters regarding renegotiable sales. The divisions send out the letters, follow up on those who do not reply, receive and categorize the responses, summarize the data and submit it to the headquarters office.

The headquarters' staff assembles the data submitted by the divisions and prepares and submits the Report for Renegotiation (RB Form 1). Headquarters also fills requests for additional data, providing specific information concerning exemptions, cost allocations, etc. Such requests are received annually from the Eastern Regional Renegotiation Board which generally is assigned Eaton's report. The last time Eaton was determined to have made excess profits was 1958.

COSTS OF COMPLIANCE

Eaton's procedures to comply with Renegotiation Board requirements have been consistently applied for several years. While Eaton does not assemble the associated costs of compliance, we were able to develop estimates of the costs involved.

These estimated costs are (1) solely applicable to the renegotiation function, (2) recurring but probably in differing amounts annually based on the volume of renegotiable sales, and (3) generally would not be considered incremental. Eaton does not compile the costs for complying with Renegotiation Board requirements. Based on data furnished by the contractor, we estimated the total costs for the fiscal 1975 submission to be $18,220. A breakdown follows:

Division costs	$14,710
Headquarters cost	3,510
Total cost	$18,220

Half of the headquarters costs is attributable to responding to the additional data requests from the regional Renegotiation Board. The above estimates are not directly supported by company records. They are based primarily on labor hour estimates provided by Eaton's divisions and headquarters. To the labor hours, we applied hourly labor rates, fringe benefits, and administrative overhead. The hourly labor rates are based on figures developed by Eaton during a study they undertook to evaluate the cost of the proposed product line reporting requirement of the Federal Trade Commission (FTC). The factors for fringe benefits and administrative overhead were also developed during the FTC study and are supported by Eaton's financial records. The methodology used was concurred in by Eaton officials.

Division costs

Total estimated costs incurred by the divisions to develop the fiscal 1975 data were $14,710. These costs are based on time estimates obtained from division personnel responsible for developing the sales data in accordance with the procedures previously described and the estimated number of letters mailed to solicit sales data from customers.

TOTAL DIVISION COST

Divisions with renegotiable sales	740 hours	
Divisions without renegotiable sales	448 hours	
Total hours	1,188 hours	
Hourly labor rate	$8	
Total direct labor cost		$9,504
Fringe benefits--17 percent of labor costs		1,616
Overhead--25 percent of labor and fringe benefits		2,780
Mailing costs-17 cents a letter		810
Total cost		$14,710

To determine the validity of the time estimates underlying these costs, we visited two of the reporting divisions. We interviewed the responsible division officials and reviewed and discussed their annual data-gathering procedure. We also examined the summary schedules prepared by the divisions during the data gathering process.

Based on data provided by Eaton, we estimated 4,767 letters were mailed by the divisions to gather renegotiable sales data for the fiscal 1975 report. Eaton estimated a cost of 17 cents for each letter (postage, typing, stationery, use of copying equipment, etc.). Since postage would be 13 cents for each letter, the estimated cost appears reasonable.

Headquarters' costs

It is estimated that headquarters incurred costs of about $3,510 to comply with Renegotiation Board regulations applicable to the fiscal 1975 report. The cost is based on estimated time spent to prepare and submit the report and fulfill the requests for additional data usually made by the regional Renegotiation Board.

TOTAL HEADQUARTERS COST

Initial filing of RB-1	80 hours	
Providing additional data	80 hours	
Total hours	160 hours	
Hourly labor rate	$15	
Total labor cost		$2,400
Fringe benefits--17 percent of labor		408
Overhead-25 percent of labor and fringe benefits		702
Total cost		$3,510

INCREMENTAL COSTS

The time spent on meeting Board requirements makes up a very small portion of many employees' workyear. Eaton officials stated that no one at the division or headquarters level would be laid off if Eaton had no renegotiable sales.

Vice President and Controller

Eaton Corporation
World Headquarters
100 Erieview Plaza
Cleveland, Ohio 44114

August 17, 1977

Honorable William Proxmire
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

At the request of the General Accounting Office, we have just completed a review of the cost to Eaton of compliance with the reporting requirements for renegotiable sales.

Eaton's total sales in 1975 were $1,558,000,000 of which $1,046,000,000 were domestic. Renegotiable sales were less than $5 million. A reasonably prepared conservative cost estimate indicates the reporting cost to be about $18/$20 thousand. While this is not an earth-shaking amount for a company such as Eaton, it is of interest to note that it has been spent each year without benefit to either Eaton or the government.

This cost of past compliance will be increased many fold by the provisions of the proposed bill. The cost of preparing product line data as required by the current proposal is about $26,250 for a typical division. In 1975, 21 plants equating to approximately 10 divisions were involved in renegotiable business. If product line reporting were limited to only the 21 plants involved in renegotiable business, the reporting cost for Eaton would increase from the $18/20,000 currently experienced to about $280,000. If the reporting covered all of Eaton's domestic plants, the cost would be $18/20,000 plus $420,000 for a total of $438,000. The product line reporting cost was developed by a detailed study of a typical division to determine the cost of complying with the F.T.C. Annual Line of Business program. We urge that consideration be given this additional cost burden in determining the reporting requirements. We will be happy to review all of the problem and cost aspects with you or your staff if this would be helpful to you.

I am pleased that the proposed legislation would not require reporting for companies with less than $5 million of renegotiable sales but would like to point out that this relief would not eliminate the cost of determining if we had unknowingly exceeded this threshold amount. This problem could be overcome by a simple provision exempting product shipped in the normal course of business but subsequently used by the purchaser to fulfill his contract obligations. Without such a provision, Eaton could be placed in the position of incurring compliance costs exceeding $400,000 to report renegotiable sales slightly in excess of $5 million. This statement is not an exaggeration. We are prepared to discuss the detailed procedures which create the cost problem. Even after having incurred this cost, we have no reason to believe an auditor would agree with our cost allocations.

As stated earlier, Eaton's renegotiable business in 1975 was less than $5 million and, consequently, would not have required the filing of a report if the proposed legislation had been in effect. We have no reason to believe this will be true in subsequent years.

We would very much like to be a substantial supplier to the military, and believe our entrance into the market would give the government a competitive wedge which could be used to it's advantage. We have been reluctant to do so because of the cost of compliance with the "red tape" involved, and public disclosure of confidential information which would be helpful to our competitors. There is a need to eliminate such barriers so companies like Eaton would feel free to enter into a truly competitive military procurement market.

Yours very truly,
EATON CORPORATION
Frank C Roberts
Frank C. Roberts
Vice President and Controller

cc: ✓Mr. Gary Chupka - U.S. General Acctg. Office
Mr. John L. Carter - U.S. General Acctg. Office

FAIRCHILD INDUSTRIES, INCORPORATED

Fairchild Industries, Inc., had total sales of about $193 million in the year ending December 31, 1975, of which 64 percent were subject to renegotiation. While Fairchild Industries has seven divisions plus one subsidiary, only two, the Space and Electronics Division and the Republic Division, had substantial renegotiable sales. Renegotiable contracts were for the design, fabrication, assembly and repair of aircraft and parts, the Space Shuttle, and electronic communications equipment.

In June 1977, Fairchild Industries testified before the Senate Committee on Banking, Housing and Urban Affairs concerning legislation to extend and amend the Renegotiation Act. Fairchild Industries did not testify regarding the specific costs to comply with the renegotiation process.

We contacted responsible officials at Fairchild Industries to determine whether compliance cost estimates had been developed. Cost estimates were not available and could not be prepared within the time frame of our review.

JOHN FLUKE MANUFACTURING COMPANY, INCORPORATED

BACKGROUND

John Fluke Manufacturing Company, Inc., Mountlake Terrace, Washington, is engaged in the design, development, manufacture, and sale of commercial electronic test and measurement instruments and systems for scientific, educational, industrial, and governmental applications. The company considers itself to be in one line of business, as defined under the U.S. Government Standard Industrial Classification (SIC)--test and measurement instruments. This firm manufactures digital and differential voltmeters, voltage/current calibrators, high voltage power supplies, frequency counters, frequency synthesizers, digital logic testers, digital thermometers, dataloggers, automatic test equipment, and systems components used and sold either individually or in manual or automatic test systems.

Fluke had total consolidated net sales of $49.2 million during its fiscal year ended September 30, 1976, including $9.3 million of renegotiable sales and $4.5 million of renegotiable-type sales exempt as standard commercial articles. All of the company's renegotiable sales for fiscal year (FY) 1976 were made by its Seattle Division which had total net sales of $31.9 million.

The Renegotiation Board assigned Fluke's FY's 1973, 1974, and 1975 filings to the Board's Western Regional Board for field review. Representatives of the Regional Board visited the Fluke Company on March 21 and 22, 1977, and the company has provided additional information on several occasions since the Board's March visit.

Fluke's system for identifying renegotiable sales and for reporting to the Renegotiation Board involves effort by the company's order processing, data processing, and contract operations departments and by its certified public accounting firm.

The company has two order processing employees who code data for automatic processing from about 60 incoming orders per day. As part of this procedure, the employees must analyze each order to determine if it should be classified as renegotiable or nonrenegotiable and code it accordingly. Fluke officials said that it is not always clear whether orders should be classified as renegotiable, so coding employees must spend considerable time searching through the contractual clauses for such evidence. Since about half of the incoming orders are advance orders, Fluke officials said that a third employee must analyze about 30 confirming orders per day for evidence that they should be classified as renegotiable and recode data if necessary. The order processing supervisor subsequently reviews coded data at shipment by comparing coding sheets and order documents with the Automatic Data Processing (ADP) printout of coded data.

Fluke's data processing department prepares a renegotiable sales report which company officials said is used exclusively for preparing the Renegotiation Report (RB Form 1). The sales report segregates renegotiable and nonrenegotiable sales, cost of sales and commissions data for each Fluke model sold. The data file is updated monthly and printed at year end.

. Once the data processing renegotiable sales report has been completed, the contract operations manager reconciles this data to Fluke's total sales shown in the financial statements by reviewing all band-processed orders for renegotiable sales and adding these to the sales shown in the renegotiable sales report. He said that hand processed orders for FY 1976 totaled about $2 million and all of this amount was renegotiable sales. The contract operations manager also determines which model numbers are standard commercial articles that are exempt from renegotiation and prepares the list of these items for attachment to the RB Form 1. Although Fluke has used the standard commercial article exemption, it has not applied for the standard commercial class exemption.

All of Fluke's employees engaged in identifying and report ing renegotiable sales have other duties. A company official told us that no employees would be released if renegotiation requirements were ever eliminated but hiring of additional personnel would be precluded for some time. He said the number of employees has not increased in recent years commensurate with Fluke's rapid growth.

CONTRACTOR'S ESTIMATED COST OF COMPLIANCE WITH RENEGOTIATION ACT REQUIREMENTS

Fluke has increased its estimates of the cost to comply with the requirements of the renegotiation program twice since

John Fluke, President, told the House Subcommittee on General Oversight and Renegotiation that his company's annual cost was $12,000. In subsequent testimony before the Senate Committee on Banking, Housing and Urban Affairs, Mr. Fluke said that, after further checking, the cost was really about $20,000. At the start of our review, the company provided us an estimate which included $37,112 of recurring costs and $4,275 of nonrecurring costs. Fluke said that efforts to identify these costs originally resulted from a cursory review of requirements and that the company was not accorded time and did not think a full blown flow-charting timestudy analysis was warranted. Fluke also said that as more thought was given to the concept of determining true costs of complying with the Renegotiation Act, more areas were discovered which formerly had been overlooked.

Recurring costs

John Fluke Manufacturing Company estimates that recurring costs of $37,112 are incurred each year to report to the Renegotiation Board. The company's estimate consists of the following costs.

Order processing:	
Analysis and coding of incoming order	5 minutes
Analysis and recoding of confirming order	6 minutes
Audit of coding at shipment	5-15 minutes
Average time per order	20 minutes
Number of orders per day	60
Number of orders per year	15,600
Cost of order processing (5,200 hours at $3.50 per hour)	$18,200
Data processing:	
Computer time	3,100
Program maintenance	5,000
Contract operations manager's time	1,500
Certified public accountant, for preparation of RB Form 1	3,000
Labor related costs, 25 percent of $25,250	6,312
Total recurring costs	$37,112

Nonrecurring costs

The company also estimates it has incurred nonrecurring costs of $4,275 for supporting the Renegotiation Board's regional representatives during their March audit. The company's estimated audit support costs consisted of the following:

Company time devoted to assisting board auditors:	
Vice president-treasurer	1 day
Corporate controller	1 day
Seattle controller	1 day
Contract operations manager	10 days

Total labor cost for 13 days	$1,500
Labor-related costs (25 percent of $1,500)	375
Certified public accountant for 5 days	2,400
Total nonrecurring costs	$4,275

ANALYSIS OF FLUKE'S COST ESTIMATE

Order processing

Fluke's estimated order processing cost was not based on actual recorded costs. Fluke has not validated the estimate and a company official said that it would be difficult to validate the added time because every order situation is different.

The time included for analyzing, coding, recording, and auditing coded renegotiation data appeared high compared to the total time used for coding orders. For example, Fluke estimates that two coding employees each code about 30 orders per day or one order every 16 minutes, whereas, Fluke estimates that the time required for analyzing and coding renegotiation data alone requires 5 minutes per order. The employees also must code a great deal of other data from the order documents not related to renegotiation. We reviewed a group of 26 orders with a Fluke official, which had been coded the previous day, to determine the amount of additional time required to analyze and code renegotiation data. We observed that none of the orders would take more than 1 minute to identify and code the renegotiation information. The official agreed that the time for these orders might be 1 minute or less, but that difficult cases are encountered which take longer. We found none of these difficult cases in our sample.

Fluke also estimated the number of orders processed per year, but did not have summary records which would enable us to verify this number. The company did have records showing that 23,766 invoices were issued during FY 1976; however, this does not represent the number of orders received since sometimes several invoices are issued for the same order.

Fluke's estimate indicates that 60 confirming orders per day are analyzed and recoded if necessary. However, a Fluke official told us that only 30 confirming orders are received each day and that a third employee analyzes them and recodes as necessary.

Although we could not determine how much order processing cost Fluke actually incurs as a result of renegotiation requirements, Fluke officials agreed that the added time would be less than the 20 minutes per order estimated. Based on our discussions with company officials and review of a limited number of coded orders, we believe the cost would be closer to the following:

Order processing:	
Analysis and coding of incoming orders	1-2 minutes
Audit of coding at shipment	2-3 minutes
Average time per order	4 minutes
Number of orders per year	15,600
Analysis and recoding of confirming orders	1-2 minutes
Number of confirming orders per year	7,800
Cost of order processing (1,235 hours @ $3.50 per hour)	$4,323

A Fluke order processing official told us that order processing times cited in the company's estimated renegotiation compliance costs of $37,112 included more than costs incurred because of renegotiation. The estimated time includes looking for and coding other unique requirements of government business such as contract requirements for inspection. This official agreed that the times shown above are better estimates of effort solely required by renegotiation requirements. At the conclusion of our review, Fluke officials said that they did not concur with the revised coding times, but they did not provide additional evidence to support their views.

Data processing

Fluke's cost estimate of computer and programing time required for compliance with renegotiation requirements was also based on estimated rather than actual recorded data. Fluke does not maintain time records which would allow us to verify the amount of time expended for renegotiation purposes.

We did determine that the cost per hour for computer time was based on FY 1978 budget data rather than the company's actual incurred cost during FY 1976, its most recently completed fiscal fiscal year. Based on FY 1976 actual cost data, the cost should have been $50 per hour rather than $62 per hour. This reduces estimated annual computer costs by $600.

Fluke estimated that 2 hours per month of computer time is required for updating renegotiation report files and 26 hours are required to run the yearend report. The time required to run the year end report appears high, but a Fluke official said that the report last year had to be run four times before it was right. He said that the process will be changed this year. The report will be run quarterly rather than annually to avoid problems encountered last year. This will reduce the time required to run the report to 16 hours for the year end report.

Contract operations

The Fluke contract operations manager's time devoted to renegotiation is also not recorded separately. Therefore, we could not verify this time estimate.

We reviewed worksheets he prepares to identify standard commercial items not subject to renegotiation. He said that about 3 or 4 days of his time are devoted to developing this list of items exempt from renegotiation. He estimates he spends an additional 11 days on other renegotiation report work.

Certified public accountant (CPA)

Fluke estimated that they pay their certified public accountant $60 per hour and that the CPA spends more than 1 week in preparing the Renegotiation Reports (RB Form 1) for Fluke and its subsidiary, Fluke Trendon. Since the CPA's billings to Fluke did not always show the charges separately for preparing the renegotiation report, we asked the CPA how much his bill is for this purpose. He said that he charges Fluke about 40 hours at his billing rate of $65 per hour or $2,600 to prepare the report.

Labor related costs

Fluke's estimated labor related costs, such as payroll taxes and employees' insurance, were based on labor costs of

$25,250. The Fluke official who prepared the estimate could not recall how he arrived at this labor cost base. We believe Fluke's estimate of the labor base should have been $19,700 which includes order processing costs of $18,200 and contract operations costs of $1,500. This labor cost base does not include data processing cost that already includes labor related costs. Nor does it include the outside CPA costs because labor related costs are not involved. This labor cost base would be $5,823 if our revised estimate of $4,323 for order processing costs were used instead of Fluke's estimate of $18,200.

Costs incurred to support Renegotiation Board representatives

Fluke estimated that $4,275 of cost were incurred to support Regional Renegotiation Board representatives who were auditing company reports assigned by the Renegotiation Board headquarters. Included in this estimate is $2,400 for services of the certified public accountant. Fluke estimated that the CPA spent 5 days on this effort. However, the CPA told us that he actually billed Fluke about $1,000.

GAO revised estimate

Based on our review and as previously discussed, we found some variations regarding the cost elements in Fluke's estimate. It appears that Fluke's estimate may be overstated by approximately $19,733. This is shown below

	Estimated cost of compliance	
	Fluke	GAO
Order processing	$18,200	$4,323
Data processing	8,100	7,500
Contract operations managers time	1,500	1,500
CPA, for preparation of RB Form 1	3,000	2,600
Labor related costs (25 percent of order processing and contract operations managers time)	6,312	1,456
	$37,112	$17,379
Difference		$19,733

Fluke revision of cost estimate at conclusion of our review

At the conclusion of our review, Fluke provided us with another revised estimate of recurring costs to comply with renegotiation requirements; however, we did not have time to extend our review to determine the accuracy of the new estimate. This revised estimate of $20,506 generally was based on the lower estimated costs indicated by our review, even though Fluke did not agree with our estimate of the time to process orders. However, the company added three additional items not considered in the $37,112 estimate.

- —Audit at shipment time should have been applied to each shipment invoice rather than each order. As a result, 23,766 invoices are audited at shipment rather than 15,600 orders.
- —Orders coding supervisors' time was not previously included for training and supervision of analysis and

coding personnel. Fluke said this would add about 10 percent to the order processing time required for identifying renegotiable business.

--No time was included for analysis and coding of about 2,600 orders received by Fluke's parts department.

Fluke said that this latest revised estimate still does not include any allocations for occupancy cost or other supportive indirect costs, or any amount for responses to vendors' inquiries concerning renegotiable business. Fluke said that this estimate also excludes any costs of training, coordination, or verification efforts related to Fluke field officers and the company's subsidiary, Fluke Trendor.

FMC CORPORATION

BACKGROUND

The FMC Corporation, with headquarters in Chicago, Illinois, is a diversified manufacturer of machinery and chemical products. Sales in 1975 totaled $2,020 million, of which $106 million represented renegotiable sales. FMC's defense equipment group which includes four plants, accounted for $98 million, or 92 percent of the renegotiable sales. FMC defense group sales are comprised of armored personnel carriers, designed and manufactured in San Jose, California; naval gun mounts and shipboard missile handling equipment, designed and produced at Minneapolis, Minnesota; and vehicle track shoes, manufactured at Anniston, Alabama. The remaining $8 million, or 8 percent, of the renegotiable sales were made by 55 plants in FMC's commercial divisions. FMC officials stated that, on the average, 15 of the 55 commercial plants have renegotiable sales.

FMC RENEGOTIATION PROCEDURES

FMC has formal procedures for compiling the information needed for the RB Form 1. Between January and April, each of FMC's 4 defense equipment plants and 55 commercial division plants is required to gather renegotiation data. This includes determining which sales are renegotiable, identifying exempt sales, and determining the costs applicable to renegotiable sales. Generally, the plants must schedule out, for individual renegotiable contracts with billings of at least $1 million, such data as contract costs, sales, and description of products sold or work performed. The information gathered at the plants is forwarded to FMC's headquarters where it is consolidated into the corporate RB Form 1 for submittal to the Renegotiation Board.

SUMMARY

FMC officials estimated that annual renegotiation compliance costs are between $923,400 and $1,751,000 and involved the efforts of between 20 to 34 full-time equivalent employees. FMC officials stated the cost will vary depending on the amount of information FMC, through experience, believes it must gather to satisfy the Renegotiation Board's data requirements, including requests for additional data.

We could not verify the accuracy of the estimates because

--the estimates are judgmental and are not based on specific accounting records, studies, or other documentation;

--the costs are part of the overhead pool which is not segmented by renegotiation effort; and

--we were able to contact only a limited number of FMC employees involved in renegotiation matters.

FMC officials said the cost estimates are based on FMC's experience with its 1971 renegotiation submittal which is currently being reviewed by the Renegotiation Board. Also, FMC officials said they had only about 10 days to prepare the estimates, and that with additional time they could have developed better estimates with some supporting documentation.

FMC officials stated that all estimated costs are recurring and are due solely to complying with the Renegotiation Act.

They stated that if there were no Renegotiation Act, the cost of the outside attorney, whose annual cost ranged from $60,000 to $150,000, would be eliminated.

Subsequently, on August 30, 1977, Mr. Robert McLellan, a vice president, wrote us and stated that FMC management would enforce a reduction in force if the workload of complying with renegotiation requirements did not exist. He stated that about 34 full-time equivalent employees were presently involved in meeting renegotiation requirements.

FMC's renegotiation procedures require that each of the company's 4 defense and 55 commercial plants gather more data than is needed for the RB Form 1 submittal. However, FMC officials stated that, through experience, the additional information is needed to verify that the basic data is correct and to respond to the Board when it reviews the RB Form 1 submittal.

FMC's RENEGOTIABLE COST ESTIMATES

In a July 1, 1977, letter to Senator William Proxmire, an FMC official estimated that FMC would save $1,715,000 annually if the existing requirements for renegotiation were eliminated. The estimate included the cost of (1) preparing the RB Form 1, (2) gathering data for the RB Form 2, including the minimum data which FMC believes is needed for the Statement of Factors, and (3) responding to various questions from the Renegotiation Board staff. The RB Form 2 is a data submiusions generally required when a contractor's filing is assigned for field review.

FMC officials stated that a large portion of the cost involves compiling minimum information on the Statement of Factors. This statement is submitted as additional information for consideration in the Board's processing of assigned renegotiation cases. These factors are (1) the reasonableness of cost and profits, (2) the capital involved, (3) extent of risk assumed, (4) contribution to the defense effort, (5) character of business, and (6) the efficiency of the contractor. FMC officials estimated that the annual renegotiation cost would decrease about 46 percent, from $1,715,000 to $923,400, if the minimum data for the Statement of Factors was not gathered. FMC officials could not provide us with an estimate of the cost for just gathering the information needed for the RB Form 1.

The following table shows FMC's estimated renegotiation costs under the existing renegotiation requirement with and without the Statement of Factors data, as well as the number of full-time equivalent employees involved in gathering data for the Renegotiation Board.

	Cost with the Statement of Factors		Cost without the Statement of Factors	
	Full-time equivalent employees	Total cost	Full-time equivalent employees	Total cost
Corporate headquarters and defense operations				
Staff directly involved in renegotiation	4.8	$ 262,000	1.3	$ 76,000
Supporting staff	13.92	624,000	3.77	178,400
Outside attorney	.5	150,000	.2	60,000
Top management	.48	96,000	.13	26,000
Total corporate and defense operations	19.70	$1,132,000	5.40	$340,400
Commercial operations				
Plants with renegotiable sales (15 plants)	6.25	$ 250,000	6.25	$250,000
Plants without renegotiable sales (40 plants)	8.33	333,000	8.33	333,000
Total commercial operations	14.58	583,000	14.58	583,000
Total FMC cost	34.28	$1,715,000	19.98	$923,400

BASIS FOR COST ESTIMATE

FMC officials stated the cost estimates are judgmental and are based on FMC's current experience with its 1971 submittal which is being reviewed by the Renegotiation Board. The officials said FMC expects to continue to make profits, consequently, the cost estimates are based on being involved in proceedings before the Board each year. FMC officials said, based on their experience, they do not expect to receive a clearance from the Board simply on RB Form 1 submittals, therefore, data has to be accumulated in anticipation of being assigned for field review and the Board's request for additional information. They stated that FMC's fiscal years 1972 and 1973 RB Form 1 submittals have been assigned for field review by the Board.

FMC cost estimates include salaries and other expenses for full-time equivalent employees.

Full-time equivalent employees

FMC officials said that the number of full-time equivalent employees represents the efforts of many people throughout the company. The officials could not provide us with a firm estimate of the number of employees involved. They did say that at least 10 employees at each of the 4 defense and 55 commercial plants contribute to gathering renegotiation data. They stated these employees, which are for the most part managerial and professional, include cost accountants, staff accountants, property accountants, purchasing and sales personnel, and material managers as well as supervisory and clerical personnel.

The number of full-time equivalent employees is an estimate by FMC officials of the people involved in renegotiation. In arriving at the number of supporting staff, FMC officials assumed that the requests for information from one equivalent employee directly involved in renegotiation will directly and indirectly, through a "ripple effect," interrupt the work of others equivalent to 80 percent of one supervisor's time, plus 100 percent of the time of 2.1 other employees.

Salaries

FMC's estimated annual salaries for employees engaged in renegotiation matters ranged from $15,000 for some supporting staff to $100,000 for top management. According to an FMC official, the salaries of those involved in renegotiation matters at one defense plant are:

Staff accountant	$18,000
Property accountant	16,500
Cost accountant	15,500
Supervisor	22,000

Other expenses

FMC cost estimates include other expenses such as fringe benefits and other payroll added costs, utilities, supplies, travel, telephone, and occupancy costs. The other expenses are estimated to be equal to the salary an employee receives. For example, both the annual salaries and other expenses of the employees in the commercial operations are $20,000 for a total of $40,000 per employee.

FMC officials stated that pricing other expenses at the same rate as employees' salaries is conservative because the overhead rate is as high as 180 percent for some plants. The officials provided us with a document for one plant showing a manufacturing overhead rate in excess of 180 percent.

EVALUATION OF FMC'S COST ESTIMATES

FMC officials could not provide us with supporting documentation to verify the accuracy of the cost estimates. No specific accounting records or other documents were maintained identifying the names of employees and the time they spent on renegotiation matters. As a result, we could not verify the number, salaries, and other expenses of the FMC employees involved in renegotiation matters. However, we did try to determine how FMC derived (1) the overall cost estimates, (2) the cost associated with the commercial plants, and (3) the amount of employee effort involved in renegotiation matters.

Derivation of FMC's cost estimates

An FMC official said that the cost estimates were prepared by a staff employee at FMC's San Jose Ordnance Plant. However, the staff employee was on vacation during our review and was not available to discuss how he arrived at the cost estimates. His supervisor stated that the estimates were primarily based on discussions between FMC headquarters' staff in Chicago, and staff in FMC's defense equipment group in San Jose. The supervisor said the estimates were essentially an estimate of employees' time spent on renegotiation matters. The supervisor said little canvassing of the various plants was made to get cost estimates from the employees involved in renegotiation.

Commercial plants' renegotiation cost

We questioned FMC officials as to why the 55 commercial plants with only 8 percent of FMC's renegotiable sales have a total cost of $583,000. We were told that all commercial plants submit RB Form 1 data and other data required by FMC's renegotiation procedures. This includes requesting information from all companies who have purchased products from the plants to determine if the products were used in renegotiable contracts. Also the plants must respond to their suppliers on whether the suppliers' products were used in FMC renegotiable contracts. FMC officials said all this takes a considerable amount of time.

We asked FMC officials for the names of employees at three or four commercial plants to contact about their renegotiation costs. We were told the costs are spread over more than one department, such as accounting, purchasing, sales, and material and that there would not be any one person at a plant who could make an accurate estimate of the cost. We were also told that because each plant is operated differently, no two plants would have the same types of costs. FMC officials later allowed us to talk to employees of one commercial plant.

We asked FMC officials for the workpapers supporting the cost estimates for the commercial plants. We were told there were no supporting documents since records of such work are not kept in the normal course of business.

We asked for copies of the sales and purchase order forms used by the commercial plants to determine the effort involved in separating renegotiable sales from nonrenegotiable sales. We were told that each plant is responsible for preparing their own sales orders and that there is little commonality between plants.

Employee effort and cost

In an attempt to determine the employee effort involved in renegotiation matters, we interviewed employees from FMC's headquarters office and one defense and one commercial plant. We also interviewed FMC's outside attorney. A senior accountant from FMC's headquarters stated he spends between 40 to 75 percent of his time on renegotiation matters. The senior accountant said he is responsible for consolidating the renegotiation information from the various defense and commercial plants into the RB Form 1. The senior accountant's time estimate agreed with the time estimate FMC officials had provided us and which they used in developing their overall cost estimate.

Officials from an FMC commercial plant with renegotiable sales stated that the time to assemble and doublecheck the renegotiation data sent to FMC's headquarters is about 3 staff months. This, for the most part, represents management time. The official also stated that an additional 3 staff months is spent on renegotiation matters, such as responding to queries from FMC headquarters and queries from other contractors wanting to know if their sales to FMC were renegotiable. The time involved agreed with the FMC cost estimates.

An official at one defense plant stated that the employees involved in gathering renegotiation data include cost, staff, and property accountants, as well as secretaries and a manager. We were told the full-time employee equivalent for preparation of the RB Form 1 is 20 percent of one employee's time. This estimate agrees with the estimates FMC officials had provided us.

FMC cost estimates for an outside attorney range from $60,000 for time spent primarily on the RB Form 1 submittal to $150,000 for also preparing the Statement of Factors. FMC officials showed us the attorney's charges of $60,000 for a 9-month period. FMC officials said the charges included all the attorney's time and most of his expenses and were for services which included preparing the Statement of Factors for FMC's 1971 RB Form 1 submittal. We pointed out the discrepancy between the $60,000 attorney charges for 9 months and the estimated $150,000 cost for 12 months. FMC officials said the attorney's level-of-effort varies considerably, depending on the demands from the Renegotiation Board. They said the attorney's billing for the most recent month was about $12.000.

We asked FMC officials and FMC's outside attorney why an outside attorney was needed for the preparation of the RB Form 1. We were told that an expert in renegotiation is needed because the reporting requirements of the Renegotiation Act are very complicated, especially in regard to the applicability of exemptions, reconciliation of the information on the RB Form 1 to the tax returns, and determination of appropriate cost allocation methods.

FMC's renegotiation procedures

We analyzed FMC's renegotiation procedures and found that about 35 percent of the data collected at each plant is needed to complete the RB Form 1. FMC officials said the remaining 65 percent of the data can be used for the RB Form 2 and other renegotiation related information the Board may request. According to FMC officials, experience has shown that all the data must be collected in anticipation that the RB Form 1 submittal will be reviewed by the Board.

CONCLUSIONS

Because FMC did not maintain records on the cost associated with renegotiation matters, we could not verify the accuracy or reasonableness of any of FMC's cost estimate.

The FMC employee who made the estimates was not available to discuss with us how the estimates were derived. Also the few FMC employees we interviewed did not give us specific details of their costs or the effort involved in gathering renegotiation data.

Time did not permit us to interview employees or examine renegotiation procedures at any of the 40 commercial plants without renegotiable sales. Therefore, we could not determine the reasonableness of the $333,000 estimated cost of gathering renegotiation data at these plants. The process of determining whether sales are renegotiable may or may not be this costly.

The magnitude of FMC's cost estimates and the amount of renegotiation data collected rests on the assumption that the Board will request supplemental data on each RB Form 1 submittal. This may be a valid assumption because FMC's 1971, 1972, and 1973 submittals have been assigned by the Board for field review. Consequently, it may be reasonable for FMC to collect additional data in anticipation of the Board's requests. However, a major portion of FMC's estimate ($791,600 of the $1,715,000 under the existing Renegotiation Act) is for preparing data for the Statement of Factors. FMC officials said that data for a new Statement of Factors must be accumulated each year. However, in our opinion, it is possible that once FMC obtains data for 1 year's

Statement of Factors, which is currently being done for FMC's 1971 submittal, subsequent submittals will consist of just updating the prior year's Statement of Factors. Therefore, FMC's cost could be lower than presently estimated.

August 30, 1977

The Honorable Elmer B. Staats
Controller General of the United States
U.S. General Accounting Office
441 G Street N.W.
Washington, D.C. 20548

Dear General Staats:

On August 19, 1977 the GAO San Francisco Regional Office forwarded to you a review of FMC Corporation's estimates of cost to comply with current Renegotiation Act requirements as well as estimates of costs that would be involved to comply with requirements if pending legislation (H.R.5959 and S.1594) were enacted. The purpose of this letter is to record our strong disagreement with the conclusion stated in that review.

The conclusion of the review states that "in our opinion, FMC does experience cost in complying with the Renegotiation Act." It goes on to state, however, that "the only cost which would be eliminated if there were no renegotiation requirements is the $60,000 to $150,000 FMC officials estimate it is spending on an outside attorney." The contradiction between recognizing that FMC has additional costs, but that the only savings would be the cost of an outside attorney, apparently results from the deduction that FMC management would take no action to make a reduction in force of the number of people equivalent to those now required to meet renegotiation requirements. It is possible that the reviewers were led to this erroneous conclusion through their discussions with various FMC accounting personnel and perhaps because we don't have a distinct department to account for the cost of renegotiation. It should be clearly understood, however, that FMC management would enforce a reduction in force if the workload of complying with renegotiation requirements did not exist. As you will have noted from the GAO review, we estimate that a total of 34.28 full-time equivalent employees are presently involved in meeting renegotiation requirements. (See GAO note below).

I would emphasize that FMC in testimony before the Senate

GAO NOTE:

The statements in our draft report referred to in this paragraph have been revised in this final report. The statements were based on comments of contractor personnel obtained during our review. The final report reflects the position of FMC management that a reduction in force would be made.

Page 2.
The Honorable Elmer B. Staats
August 30, 1977

Banking Committee and subsequently in my letter of July 1 to Senator Proxmire made clear that the costs we now experience in complying with renegotiation requirements can only be expressed as estimates and it was our agreement with Senator Proxmire that GAO examine these figures on the bases that they are estimates. We have not in any way suggested that we keep accounting records to separate renegotiation costs. The review necessarily, therefore, could address itself only to an examination of estimates.

It should especially be recognized that the additional cost to meet the requirements of proposed legislation can only be an estimate. It is obvious, therefore, that no historical documentation exists. Beyond the present requirement of 34.28 full-time equivalent employees to meet current renegotiation matters, it is our estimate that there would be an additional 42 full-time equivalent employees required to meet the requirements of pending legislation.

If the reviewers agree with the methodology followed to develop our estimates, it follows that they must essentially agree with the estimates. If they agree with the estimates (or at least approximately so), they cannot reasonably conclude that the only cost to be eliminated is that of an outside attorney. Rather, it can only logically be concluded that our renegotiation costs as estimated would be eliminated if there was in fact no renegotiation requirement.

We would appreciate it if a copy of this letter could be made a part of any statements GAO may make on this matter or any distribution of the review report.

Sincerely yours,

Robert McLellan

BEST DOCUMENT AVAILABLE

vz

cc: Mr. Richard Guttman
U.S. General Accounting Office

HEWLETT-PACKARD COMPANY

In testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs in June 1977, David Packard, Chairman of the Hewlett-Packard Company (HP) stated it cost his company between $160,000 and $180,000 each year to deal with renegotiation matters. To support these costs, Hewlett-Packard staff provided GAO with the following statement of renegotiation costs for calendar year 1976.

	Cited by H-P	Examined by GAO
Order processing costs	$ 77,000	$ 70,000
Renegotiation report preparation costs	82,000	82,000
Additional requested information costs	20,000	20,000
Data processing costs	9,000	9,000
Other renegotiation-related costs	10,000	-
Total	a/$198,000	b/$181,000

a/ Rounded. Also, Hewlett-Packard Company's cost schedule contained two estimates for order coding costs which differ by $49,500. The larger amount would increase the total cost estimate to $247,000.

b/ Rounded

The above costs include those associated with preparation of the contractor's 1975 renegotiation filing and accumulation of data for the 1976 filing, as well as costs incurred to provide the Renegotiation Board with additional information relating to the contractor's 1972 filing which was assigned by the Washington Renegotiation Board to its Western Region for review for possible excess profits.

To evaluate the validity of the costs cited to comply with the renegotiation requirements, we examined the basis and support for $181,000 (91 percent) of the cost specified on Hewlett-Packard Company's statement of costs. In summary we found that: (1) most of the costs are based on estimates of staff time expended on various renegotiation matters which cannot be readily validated due to an absence of formal documentation and records of actual staff time charged to renegotiations; (2) documentation is available in the form of correspondence and worksheets which indicate a considerable effort was expended on renegotiation matters by the contractor's staff and that in this context there are costs involved; and (3) about $147,000 of the $181,000 relate to activities which are recurring, the remainder were related to nonrecurring activities.

Generally, we were unable to identify the incremental cost associated with these recurring activities because most of the Hewlett-Packard Company staff involved in renegotiation devote a relatively minor portion of their total time to this activity.

The following chart is a breakout of the $181,000 we examined, classified into the major areas of renegotiation effort:

Annual renegotiation filing	$139,000
Annual standard commercial article and class exemption	8,000
Annual new durable productive equipment exemption	5,000
Development of new series of renegotiation computer programs	14,000
Additional information provided board regarding 1972 filing	15,000
Total	a/$181,000

a/ Costs cited were rounded to nearest $1,000.

BACKGROUND ON HEWLETT-PACKARD COMPANY

Hewlett-Packard Company is a major designer and manufacturer of precision electronic equipment for measurement, analysis, and computation. The company manufactures more than 3,500 different products in approximately 30 product divisions. Each division is organized to function like a separate business with its own set of products, research and development laboratories, manufacturing facilities, and marketing and administrative staffs. Product divisions are organized into six major product groups:

(1) electronic test and measuring instruments and systems, (2) computers and computer-based systems, (3) calculators, (4) solid-state components, (5) medical electronic products, and (6) electronic instrumentation for chemical analysis.

Hewlett-Packard's 33,000 employees are spread out among manufacturing plants in 17 locations in the United States and 8 overseas. The company also has 172 sales offices in 65 countries, of which about 70 are in the United States.

In 1976, H-P passed the billion dollar mark in sales for the first time with earnings for the year of $90.8 million. International orders account for about half of H-P's business.

For 1974, H-P reported renegotiable sales of $113 million out of total sales of over $884 million. Hewlett-Packard reduced the actual sales subject to renegotiation to $24 million by claiming $89 million in exemptions. The exemptions claimed consisted of $42 million under the standard commercial article exemption, 1/ $33 million under the standard commercial class exemption, 2/ and $14 million under the new durable productive equipment exemption. The standard commercial product article and class exemptions are not mandatory as they can be waived by the contractor and, therefore, it is the contractor's option

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1/To obtain this exemption, at least 55 percent of the total sales of each product must be nonrenegotiable.

2/To obtain this exemption, at least 55 percent of the total sales of each class of products must be nonrenegotiable.

whether or not to devote additional time developing and supporting these exemptions.

Hewlett-Packard's 1975 renegotiation filing which was submitted to the Renegotiation Board in January 1977 was comparable to the 1974 filings in that it contained approximately the same percentage of renegotiable sales for which exemptions were claimed (79 percent in 1974 and 77 percent in 1975). In 1975, renegotiable sales reported totaled $126 million and exemptions, $97 million.

The Renegotiation Board official told us H-P's renegotiation filing differs from other contractors' filings in the extent to which renegotiable sales are claimed as exemptions. Board officials stated that the percentage of renegotiable sales claimed as exemptions is high and that the total dollar amount is not only high but quite unusual compared to other contractors. The Board reported that in 1974 the exemptions claimed by H-P represented 8 percent of all exemptions claimed under the Renegotiation Act by all contractors in all industries.

Hewlett-Packard cited the 10 following activities as annually performed to prepare the renegotiation reports.

1. The coding of each domestic order as either a renegotiable prime contract sale, a renegotiable subcontract sale, or a nonrenegotiable sale.

2. The annual extraction and summarization of data relating to actual shipments to obtain renegotiable sales.

3. The reconciliation of renegotiation sales data to official accounting records and tax return.

4. The identification and summarization of sales eligible for the standard commercial products class exemption by product class.

5. The identification and summarization of those sales not eligible for the class exemption but eligible for the standard commercial products article exemption by specific product.

6. The review and identification of the sales not eligible for the standard commercial products exemption but possibly eligible for the new durable productive equipment exemption.

7. The summarization of sales by H-P divisions as to renegotiable prime contract, renegotiable subcontract, and nonrenegotiable and the reconciliation by each division to their official accounting and tax records.

8. The calculation of cost of goods sold relating to renegotiable sales which requires the identification and elimination of intra-corporate sales, the reclassification of material, labor, and overhead transfers, the summarization of research and development and manufacturing overhead expenses by major account.

9. The classification of other income and expense items such as marketing by major account.

10. The preparation and filing of the annual renegotiation report and required schedules.

Hewlett-Packard also codes each domestic order as either a government or commercial sale for use in claiming the standard commercial products (catalog) exemption from submission of cost or pricing data under Public Law 87-653 (Truth-in-Negotiations Act). The coding of a sale for compliance with Truth in Negotiations regulations and the Renegotiation Act is performed by the same H-P order-processing clerks, along with other coding tasks as part of the process necessary to input a sale into H-P's computerized records system. However, different codes are used and different computer reports are generated to identify standard commercial products under each of the two laws. This is necessary because not all sales to the Government are renegotiable sales. For example, a sales to the Veterans Administration or Department of Health, Education and Welfare would be considered a Government sale under Truth in negotiations regulations, but as a nonrenegotiable sale under the Renegotiation Act.

ORDER CODING COSTS

Hewlett-Packard cited $77,275 as the cost associated with the identification and coding of individual sales (customer purchase orders) as renegotiable or nonrenegotiable. We examined H-P's support for $70,825 of this cost which consisted of labor and fringe-benefit costs for order processing clerks ($49,500) and supervisory personnel ($12,500), and occupancy costs including the telephone ($8,825).

Hewlett-Packard's government reporting manager, who prepared the cost statement, told us these costs are estimates because H-P staff do not separately record and report the time they spend on renegotiation. He also told us the estimates were not based on time and motion studies on how order processing clerks spend their time. The $49,500 cost estimate for order processing clerks was based on an estimate of 1 minute per order to code a sale for renegotiation. 1/ We were also

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1/H-P's statement also contained a $99,000 figure based on 2 minutes per order. H-P's Government Reporting Manager stated different estimates were received over the phone from the company's regional sales order managers.

told the $12,500 supervisory cost was a rough estimate of the minimum annual cost, and it was not based on any specific study, or inquiry, of the time supervisors spend reviewing the work of order-processing clerks regarding renegotiation. The $8,875 cost estimate was based on 1/90 of the total occupancy and telephone cost associated with order processing because 1 of the 90 items on the order coding sheet deals with renegotiation.

Nationwide, H-P has approximately 70 sales offices and the equivalent of about 200 order processing clerks who processed approximately 450,000 orders in calendar year 1976. We visited one large sales office with 13 full-time order processing clerks to ascertain how much time was devoted to renegotiation coding and if any of the clerks' jobs would be eliminated if renegotiation requirements were discontinued.

Our discussions with the sales office manager, two supervisors, and three order processing clerks disclosed that the effort involved in coding an order for renegotiation can vary greatly from a matter of seconds to considerably more time in those instances where it was necessary to follow up with a customer to obtain additional information regarding renegotiation. The sales office personnel we contacted were unable to provide us with an estimate of how much time they devoted to renegotiation coding because it is only one of many matters they dealt with when coding a sales order. The sales office manager further stated that no sales office positions would be eliminated if renegotiation coding requirements were discontinued.

Hewlett-Packard's order-processing clerks examine individual incoming sales and code, on a worksheet for keypunching, whether the sale is subject to renegotiation. At the same time, other information is also entered on the worksheet for input into H-P's computerized records system. Among this other information are the following: (1) whether the sale is a Government or commercial sale under Public Law 87-653; (2) the customer's purchase order number; (3) any government contract number; (4) the priority rating; (5) the required delivery date; (6) whether the sale is taxable; (7) which salesman gets the commission; (8) any applicable discounts; (9) the quantity, product number, and the price for each item ordered; (10) where to deliver; and (11) where to invoice.

To get some idea of the effort involved in coding an order for renegotiation, we examined 36 recent sales, 11 of which were provided by H-P in response to our request for examples where the coding for renegotiation was not routine. For the 25 sales pulled at random by H-P staff from their sales files, we were able to readily ascertain from the information contained on the customer's purchase order whether the sale was subject to renegotiation.

We also had no problem ascertaining whether the sales were renegotiable for the 11 sales which H-P maintained some problem was encountered by the order-processing clerks in coding for renegotiations. We could envision that an order processing clerk may have had a question on how to code the orders, but, in our opinion, the clerk's supervisor should have been able to resolve the question without any followup with the customer.

In the case of six of these 11 orders, sufficient information was available to clearly identify whether the sale was renegotiable. For example, one order was from a University of California activity located at a Veteran's Administration Hospital; a second order was from the Tennessee Valley Authority; and, a third from a customer with an address at Arnold Air Force Station and a Department of Defense Priority rating specified in the order.

Three of the 11 orders involved processing a change order and recoding for renegotiation based on additional information contained in the customer's confirmation (purchase order). However, the additional information also changed the commerciality coding under Public Law 87-653 for all three orders, the Department of Defense priority rating for two of the orders, and the government contract number for one order. Sufficient information was contained in the confirmation to identify the correct renegotiation coding.

Coding the remaining two sales for renegotiation probably involved additional time and judgment on the part of the order processing clerks or their supervisor, but in our opinion, there should not have been any significant problem. Both orders involved possible exclusion from renegotiable sales based on "the under $1,000 and required delivery in less than 30 days" exemption provision. One order from the Energy Research and Development Administration specified the required delivery date as "immediate" which H-P staff claimed presented a problem as to whether the order should be considered as requiring delivery in under 30 days. The second order, from the Air Force, involved an amendment which slightly changed the price discount. Hewlett-Packard staff claimed this presented a problem as to whether the original order date or the amended order date should be used when applying the "under 30-day required delivery date" provision for exclusion.

RENEGOTIATION REPORT PREPARATION COSTS

The renegotiation costs listed by H-P for calendar year 1976 included $81,620 for renegotiation report preparation costs. We examined H-P's support for the $81,620 and noted that, for the most part, it consisted of estimates of staff time devoted to various renegotiation matters, and that these estimates were not based on records or reports of actual time charges. Since H-P's staff do not record the time they spend on specific jobs of this nature, we were unable to verify the accuracy of the $81,620. H-P staff did show us supporting documentation which consisted of correspondence, memos, schedules, workpapers, travel records, and computer reports with extensive manual notations which indicated a considerable amount of staff time was expended in preparing renegotiation reports.

By reviewing available documentation and from discussions with B-P staff members, we identified the four following renegotiation tasks as those which were included in the $81,620 total:

1.	Preparing the annual renegotiation filing.	$59,281
2.	Applying for the standard commercial article and class exemption.	8,261
3.	Applying for the new durable productive equipment exemption.	5,311
4.	Developing a series of new computer programs.	8,767
	Total	$81,620

The $59,281 associated with preparing the annual renegotiation filing consisted of $42,860, attributed by B-P's staff to the effort involved at the company's various divisions, and $16,421 to the effort at corporate headquarters. For the $42,860, we were told by B-P's government reporting manager that he estimated the salary and fringe-benefit costs a division would expend in responding to his request for information on the division's sales and cost of goods sold. We were shown a January 1976 request sent to the company's 28 domestic divisions which involved completing five schedules. We verified that the divisions completed the schedules. We contacted a cost accounting supervisor at one division who told us the division devoted approximately 12 staff days to complete the schedules, and that the schedules were not needed by the division for any other purpose. B-P also provided us with cost estimates to complete the same schedules in 1977 which were telephoned to the corporate office by six of its divisions. The estimates ranged from $342 to $2,724.

The $16,421 corporate reporting costs consisted of estimates of salary, fringe benefits, travel, and occupancy costs which B-P's government reporting manager told us he arrived at, based on his personal knowledge of what was done during calendar year 1976, and his review of various correspondence, calendar notations, travel vouchers, and workpapers. He also identified the specific staff members involved. We examined various workpapers which contained renegotiation information scheduled and computed on a divisional and consolidated basis. We also confirmed with the Renegotiation Board's Western Region that they expect a contractor to develop renegotiation data on a division basis and to be able to reconcile such data with the contractor's official accounting records and financial statements.

The $8,261 in estimated costs associated with applying for the standard commercial article and class exemptions consisted of salary and fringe benefit costs. B-P's government reporting manager told us he estimated the amount of staff time he and his staff spent on this task in 1976. He showed us the information sent to the Renegotiation Board, workpaper schedules, and a computer listing of sales by division and product number with extensive manual notations and computations relating to standard commercial product class and article exemptions.

According to H-P's government reporting manager, the $5,311 estimated cost of applying for the new durable productive equipment exemption was arrived at by estimating how much time he and his staff devoted to the effort and also the time spent by the various divisions' staff he contacted. He provided us with a four page listing which identified some 22 tasks performed, the names of the division staff contacted and the estimated staff hours involved.

The $8,767 estimated cost relating to developing a series of new computer programs to extract renegotiation information from H-P's computerized records system consisted of salary and fringe-benefit costs. To support their estimate, H-P's government reporting staff showed us correspondence sent to the company's divisions requesting information, informal notes taken at meetings, computer program flow charts developed, and the identification of H-P computer staff contacted. We contacted one of the computer staff members cited who confirmed an effort had been expended developing a new series of computer programs for renegotiation.

ADDITONAL REQUESTED INFORMATION COSTS

Hewlett-Packard cited $19,800 as the cost to comply primarily with the Renegotiation Board's requests for additional information during calendar year 1976. While we were unable to verify the accuracy of this claimed cost, we examined H-P's support and noted that $14,800 was attributed to the effort involved in providing information concerning H-P's 1972 renegotiation filing which was under assignment to the Board's Western Region, and $5,000 was attributed to the time devoted to renegotiation matters by the next level H-P manager above the H-P government reporting manager.

In support of the $14,800, H-P provided us with a three page listing, by month, of the government reporting manager's cost estimate of the staff days and travel devoted to providing the Board with additional information. The listing cited telephone contacts with the Board, visits to the Board, and revised cost and sales information provided the Board. We examined selected travel vouchers, correspondence and detailed workpaper schedules that supported the fact that the Board had requested additional information and that H-P had expended some staff time to develop the information.

Hewlett-Packard's government reporting manager told us the $5,000 attributed to the time his former boss spent on the renegotiation was in addition to this indiviudual's time already included in the above $14,800. He also stated the $5,000 was a rough estimate for which he had no specific support. We contacted the individual involved and were told he was responsible for three H-P departments at the time, one of which was Government reporting. He was unable to provide us with a precise estimate of how much time he devoted to renegotiation matters during calendar year 1976, but did state that, in his opinion, the $5,000 figure would not be unreasonable.

DATA PROCESSING COSTS

Hewlett-Packard cited $8,560 as data processing costs associated with its renegotiation efforts in calendar year 1976. We examined H-P's supporting documentation and noted that $4,760 was related to the development and testing of a series of new computer programs, and $3,800 was related to compiling renegotiation sales information for the annual filing with the Renegotiation Board.

In support of the $4,760, H-P showed us computer service billings and correspondence from the company's Corporate Marketing Service. We contacted an official of Corporate Marketing Service and were told that $4,360 was based on the actual hours spent on the new computer programs by two programers and the estimated time spent by a third programer. We were also told the salary rate used for programing was H-P's standard rate charged for such services. An additional $400 was supported by billings for computer time which we were told was used to generate a mid-year trial computer run to ascertain if portions of the existing computer renegotiation sales program would be acceptable for incorporation into the new series of programs under development.

To support the $3,800 computer cost related to compiling the renegotiation sales information for the annual filing, H-P also used the same aforementioned computer service billings and correspondence. From this documentation, H-P staff identified

$1,200 of computer time using the new series of computer programs, and $1,800 of computer time using the prior programs. In addition, H-P's government reporting manager told us $800 was included to cover the computer time incurred by the various H-P divisions for renegotiation purposes.

OTHER RENEGOTIATION RELATED COSTS

An additional $9,920 was cited by H-P as relating to attendance at renegotiation seminars, visits to various company divisions to discuss renegotiation matters, discussions of renegotiation matters at contract managers' meetings, work on formal renegotiation procedures, and a task force's efforts in developing renegotiation and commerciality guidelines for order-processing clerks. Due to the relatively small amount involved and our tight reporting deadline, we did not examine the support for these cited costs.

HEWLETT-PACKARD COMPANY
1501 PAGE MILL ROAD
PALO ALTO, CALIFORNIA 94304

ROBERT L. BONIFACE
EXECUTIVE VICE PRESIDENT

August 25, 1977

Mr. Richard W. Gutmann, Director
Procurement & Systems Acquisition Division
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Gutmann:

We acknowledge the opportunity to read your Workpaper Summary entitled "Review of Renegotiation Act Compliance Costs Cited by Hewlett-Packard Company in Testimony Before Senate Committee on Banking, Housing and Urban Affairs," Code 950422.

We are disappointed that the document does not reflect either of the two major points we made during the exit interview, on which all of our participants believe there was some concurrence by members of your audit team. We here reiterate the points and then their significance in the larger context in which we sought the audit.

1. On pages 6 and 9 in particular you confirm that compliance with the Renegotiation Act requires a substantially different collection and aggregation of data than that required under PL 87-653 (Truth in Negotiations Act). This finding is basic to any assessment of the challenge raised to our testimony before the Senate Committee on Banking, Housing and Urban Affairs in June of this year. As such it must be reflected as a separate item in the summary findings on page 2. Further, Congress needs to know that there is a substantial difference in the reporting requirements of these two acts and that compliance with Truth in Negotiations does not relieve the contractor of the burden of compliance with Renegotiation.

2. Your summary chose to emphasize that our "estimates of staff time expended on various renegotiation matters ...cannot be readily validated...", a point which recurs throughout the Workpaper Summary. Its recurrence, however, is always as a caveat to a finding that some

> effort was expended and apparent acceptance of the fact that the estimates were neither unrealistic nor unreasonable, e.g. "...the effort involved in coding an order for renegotiation can vary greatly from a matter of seconds to considerably more time in those instances where it was necessary to follow up with a customer to obtain additional information regarding renegotiation" (page 8). In each category of costs your Workpaper Summary concurred that staff time was expended. In no category does it assert that the estimates made were unreasonable or unrealistic. If in fact you neither challenge nor validate our estimates, Congress needs to have both sides of that coin in your page 2 summary point.

The report makes a special point "that only one job would be eliminated" if renegotiation was terminated. We question the validity of this criterion as a measure of incremental cost. Renegotiation is a task for a great many people within Hewlett-Packard. If renegotiation is eliminated, tasks would be reassigned -- a normal and everyday function of administration, and on a cumulative basis fewer people would need to be hired as the company continues to grow. During calendar year 1976 it took over 17,700 hours to comply with the requirements of the Renegotiation Act. This cumulative effort (tasks) equates to 8-1/2 people. Looking to the future of the company, this means a maximum of eight fewer people are needed for an expanding work force if renegotiation is eliminated.

We appreciate that you were asked to review our costs. All such reviews have a purpose and a conclusion is sought. Although the report contains a summary statement within the second paragraph on page 2, it does not include a conclusion with regard to whether there is any factual support for the charges made by the Chairman of the Renegotiation Board in his testimony before the Senate Committee. You will recall that the Chairman made two points: (1) the Hewlett-Packard estimate of compliance is "erroneous in every respect" (lines 12 and 13, page 189), and (2) "the records the contractor maintains for Public Law 87-653 are identical to those required for renegotiation," and therefore the contractor "was irresponsible, if not misleading" in submitting testimony to Congress that "the cost of such recordkeeping is attributable to the renegotiation process" (line 21, page 189, through line 2, page 190). Similar statements appear in the testimony beginning at line 16, page 212, through line 10, page 214.

We believe the Senate Committee and Hewlett-Packard are entitled to a direct answer to such charges to the extent that the findings of the audit address these issues. Further, the answer to the charges must be on the public record along with the charges themselves and must have the visibility of inclusion in the summary.

It is our hope that all of the concerned parties in this issue of renegotiation will have benefitted from this audit. We believe it has been helpful in understanding the magnitude of effort required and the extent to which a regulation of this kind can permeate throughout a commercial contractor's organization.

Sincerely,

Robert L. Boniface

Robert L. Boniface

RLB:ac

cc: H. J. D'Ambrogia, GAO, San Francisco
John Young, Exec. V.P, Hewlett-Packard
David Packard

TELEDYNE, INC.

We contacted Mr. Barry Shillito, vice president, Teledyne, Inc., in order to validate the cost of compliance estimate provided during recent Senate Banking Committee hearings. Mr. Shillito advised us that his testimony was not based on company cost estimates. The $20,000 estimate per Renegotiation Board filing was based on personal experience, intuition, and discussions with members of the Financial Executives Institute. In essence, his testimony was based on Financial Executive Institute data presented in House and Senate testimony.

AEROSPACE INDUSTRIES ASSOCIATION OF AMERICA, INC.

The membership of the Aerospace Industries Association of America, Inc. (AIA), is comprised of some 45 corporations, many of which are major Department of Defense and National Aeronautics and Space Administration suppliers. The Association has testified several times concerning the renegotiation process, most recently before the Senate Committee on Banking, Housing and Urban Affairs in June 1977. During these hearings AIA testified that a survey of member companies indicated that costs to industry to comply with the Renegotiation Act were twice as great as amounts recovered by the Renegotiation Board.

We obtained the study upon which the AIA based its estimate that industry costs were double the amount returned to the Treasury. The study was previously supplied to the Joint Committee on Internal Revenue Taxation in September 1975. The study was based on FY 1970-1974 information. The AIA states that as a trade association it does not identify any particular company but only publishes survey figures in the aggregate. Pursuant to such policy, supporting data (i.e., input from member corporations) has been destroyed.

The AIA calculated that the average annual cost to industry during the period 1970-1974 was about $45 million, whereas according to Renegotiation Board reports, and assuming a 50 percent tax rate, the average net return to the U.S. Treasury was approximately $24 million. These figures would support approximately a 2:1 ratio.

The method used by AIA to calculate average annual industry costs is as follows:

Nine of the largest AIA member companies were surveyed. The cost to comply ranged from a high of $225,000 to a low of $50,000. The total company costs were divided by the number of organizational entities in each company and the average annual cost for each organizational entity involved was $5,865. When the very high and very low cost-to-comply estimates were discounted, the AIA survey indicated that a figure of $100,000 for a large company and $5,000 for a small company would be reasonable. The cost for a small company is based on the assumption that it would incur costs similar to an organizational entity of a large company. As noted previously, we did not have access to the data compiled by AIA to verify its accuracy.

The filing companies were stratified by size and the average annual industry cost was determined as shown below. Again, we cannot determine the validity of this stratification due to lack of data; however, the number of filings appears reasonable based on Renegotiation Board estimates.

Number of filings	Percent of total filings	Cost per filing	Total
25	.6	$100,000	$ 2,500,000
50	1.1	75,000	3,750,000
225	5.2	50,000	11,250,000
1,500	34.3	10,000	15,000,000
2,570	58.8	5,000	12,850,000
4,370	100.0		$45,350,000

This results in an average annual cost of about $10,300 per filing.

ENCLOSURE 2 ENCLOSURE 2

COMPARISON OF CONTRACTOR ESTIMATES WITH RENEGOTIATION BOARD STUDY

COMPARISON OF CONTRACTOR ESTIMATES WITH RENEGOTIATION BOARD STUDY

In March 1977, the Renegotiation Board completed a study for the Office of Management and Budget on industry costs of renegotiation. The study estimated that the average contractor's cost to file was over $3,300. When multiplied by the 3,067 filings received in FY 1976, the projected total cost to industry is over $10 million each year.

We were informed by the Board that its estimated cost represents the cost per individual filing. When a company with a divisional corporate structure files a report, the Board counts this as a single filing. But when a company that has subsidiaries files an RB Form 1 report, each subsidiary must also file a report. These filings are counted as separate filings by the Board. The indicated cost estimates by the Board for the three firms in its analysis are just for the parent companies and do not include the filing cost for any subsidiaries. For example, we were told that the Board's estimate of $325 for Hopeman Brothers discussed below, does not include the filing costs of its four subsidiaries. Further, the $130 estimate for Astrosystems, also discussed below, does not include the filing cost of its subsidiary.

The Renegotiation Board analysis was based on data for three different contractors. These three contractors were selected because the Renegotiation Board believed the contractors' renegotiation costs to be typical of companies with similar sales volume. The three contractors, Astrosystems, Inc., Hopeman Brothers, Inc.; and Martin Marietta had renegotiable sales of about $1.1 million, $10 million and $275 million, respectively. All three cases were assigned to regional boards and costs were estimated for the initial filing and subsequent expenses when an assignment was made. The following table illustrates costs to the contractor.

	Cost of Renegotiation				
Firm	80 percent Unassigned	20 percent assigned	Total Avg. cost of group	Percent of filing	Average group cost X filing percent
ASTRO Systems ($1-10 million sales volume)	a/$130	$2,080	$520	35	$ 182.00
Hopeman Bros. ($10-50 million sales volume)	b/325	3,575	975	55	536.25
Martin Marietta (Over $50 million sales volume)	16,250	65,000	26,000	10	2,600.00
	Total			100	$ 3,318.25

a/The Boards estimated cost of compliance with the Renegotiation Act for the company including its subsidiary company would be $260.

b/The Board's estimated cost of compliance with the Renegotiation Act for the company including its subsidiary companies would be $845.

In all three cases, direct labor expenses were calculated by multiplying salary rate and length of time required. All direct labor was increased by 30 percent to account for fringe benefits. No other cost elements were included in the analysis. As shown in the table, the costs to comply increased dramatically when the filing was assigned to a regional board.

We contacted the three contractors included in the Board's analysis. We were able to obtain information at two firms. The large contractor, Martin Marietta, could not prepare cost estimates within the timeframe of our review. The results of work at the medium contractor, Bopeman Brothers, indicates that the estimated costs ascribed to it in the Board's study are understated. The degree to which it is understated cannot be determined.

Regarding the small contractor, Astrosystems, Inc., we believe the estimated costs in the Board's study may have been understated because the Board's estimate did not contain provisions for all of the types of costs that the contractor claims to incur in complying with the Renegotiation Act. Although data obtained from Astrosystems could not be substantiated, we believe it is reasonable to assume that costs of this nature are in fact incurred in complying with the act.

ASTROSYSTEMS, INCORPORATED

Scope and work done

We obtained and reviewed the Astrosystems, Inc., costs of complying with the renegotiation requirements. Our review included discussion of the contractor's support and rationale for the cost data prepared and a test of data in support of the costs. We also reviewed the information contained in the Board's analysis of renegotiation filing costs as it pertained to "A" company by discussions and review of pertinent data at Astrosystems.

Data from contractor included in the Board's study

Astrosystems, Inc., is engaged in the design and manufacture of electronic and electromechanical products for precision monitoring and control of military, aerospace and industrial processes. It has two wholly owned subsidiaries.

Contractor representatives said that Astrosystems files an RB Form 1 (Standard Form of Contractor's Report for Renegotiation) for its consolidated business and also files separate RB-1's for Astrosystems and one of its subsidiaries. We were told that Astrosystems has renegotiable and nonrenegotiable sales and does both prime and subcontract work. The contractor's representatives said that Astrosystems usually files and is granted, for renegotiation purposes, the commercial article exemption and makes use of the exemption for certain durable test equipment it sells.

According to Astrosystems' RB-1 report for its fiscal year ended August 31, 1976, the company's total sales consisted of the following:

	Total (000 omitted)
Renegotiable sales	$2,347
Nonrenegotiable sales	
Commercial article exemption	149
Durable productive equipment exemption	1,048
Other	2,704
Total	$6,248

Astrosystems' costs to comply with the renegotiation requirements were estimated at about $12,600 annually according to information developed by the contractor. These costs were based on its experience in preparing RB-1 filings.

Astrosystems, Incorporated

Annual Costs for Complying with Renegotiation Requirements

Preparation of RB-1 Report	Amount
Order coding, correspondence and followup (as to renegotiability) with customers, analysis and summary of sales invoices including preliminary analysis for durable productive test equipment, commercial article classification, and related supervision	$2,950
Determination of costs and expenses related to renegotiable sales, preparation of RB-1 and supporting schedules	1,950
Determination of commercial class of articles, durable productive test equipment, final management review of RB-1 and schedules	1,500
	$6,400
Fringe benefits (15 percent)	$1,000
	$7,400
Outside accounting and legal costs related to RB-1 preparation, footnote to annual report	5,200
Total	$12,600

The $12,600 company estimate compares with the $260 cost estimate of the Renegotiation Board discussed earlier. Astrosystems' costs are essentially a detailed estimate prepared by the contractor's controller who has been directly involved in the RB-1 preparation. We verified the weekly salary rates and fringe-benefit factor used to determine the costs incurred. To the extent that the costs were based on estimates of personnel time spent on work related to the RB-1 report or were allocations of costs for outside legal and accounting services, they are not, in our opinion, susceptible to audit verification.

We noted that Astrosystems' RB-1 report was supported by a file of worksheets, summarizations and analysis. We also observed a mass of material, supporting worksheets and data which was prepared in response to the Board's assignment of Astrosystems' FY 1969 results. Our observation of these materials and discussions with contractor representatives indicates that substantial effort was involved in complying with the renegotiation requirements.

The Renegotiation Baord analysis

Representatives from Astrosystems disputed the costs contained in the Board's analysis transmitted June 9, 1977, with respect to "A" Company." They stated that they also disagreed with figures they understood had been quoted during hearings on the bill.

According to a copy of a letter of June 2, 1977, Astrosystems wrote to Congressman Lester Wolff, New York, advising him of its estimate ($12,000 per year for filing). The letter states that the costs attributed to Astrosystems "* * *, was not supplied by Astrosystems and in fact is considerably understated."

Astrosystems' representatives said that no one from the Board had contacted them to develop the figures cited in the analysis.

Conclusions

Based on our review, we believe that

--the contractor's estimated costs are documented to the extent possible and were realistically described. However, all of the costs are based on estimated employees' time that is not susceptible to audit verification. Also, it should be noted that costs related to obtaining exemptions are discretionary in that contractors have the option of claiming or not claiming exemptions.

--the costs cited for A Company in the Board's analysis appear to be understated because the Board's estimate did not contain provision for all of the types of costs the contractor claims to incur in complying with the Renegotiation Act.

HOPEMAN BROTHERS, INCORPORATED

Hopeman Brothers, Inc., and its five domestic subsidiary companies had total sales of about $21 million in the year ending December 28, 1975, of which 33 percent were subject to renegotiation. Renegotiable subcontracts were primarily for engineering, manufacturing and installing materials to outfit large marine vessels, particularly the fabrication of light sheet metal desks, chairs, lockers, and other furniture.

We contacted responsible officials at Hopeman Brothers to determine whether compliance cost estimates had been developed. Hopeman Brothers officials told us cost figures had not been developed, but could be prepared within the time frame of our review.

At our request, Hopeman Brothers' personnel performed an analysis of the time required to comply with the Renegotiation Act.

Hopeman Brothers did not compile costs to comply with renegotiation requirements as they were incurred. Rather, the estimates of direct time were based on employee recollection supplemented by the working papers retained by Hopeman Brothers which were used to file renegotiation reports. Hopeman Brothers officials acknowledge that their estimates are not documented but believe them to be conservative.

Several Hopeman Brothers' officials were directly involved in the renegotiation process. The officials worked on renegotiation matters on an as-needed basis. All renegotiation efforts were made after all tax and financial accounting requirements were completed. Since the employees involved generally spent only a small fraction of their time on renegotiation matters, we were advised that no employees would be laid off or positions eliminated if there were no Renegotiation Act. Hopeman Brothers' employees are not relieved of other duties to deal with renegotiation matters, but they believe that productive, alternative work would be available if there were no Renegotiation Act requirements.

Estimates of costs for most recent filing (not assigned)

Hopeman Brothers submits a total of six filings per year for itself and subsidiaries. As shown below, Hopeman Brothers estimated its costs for the most recent filing to be about $2,045.

Direct salary expense (18 days, total of 4 employees)	$1,645
Fringe benefits at approximately 25 percent	400
Total cost of FY 1975 filing	$2,045

The $2,045 company cost estimate compares with the $845 cost estimate of the Renegotiation Board discussed earlier. This filing had not been assigned to a regional board. Hopeman Brother' officials identified eight tasks which were necessary to comply with the renegotiation process beyond all other tax and accounting requirements. It was estimated that 18 days of direct time were required to complete the filing. In addition to employee salaries, fringe benefits, including Social Security contributions, retirement, insurance, vacation and holidays were estimated to be about 25 percent.

Cost effect of assignment

Hopeman Brothers' 1971 and 1972 filings were assigned by the Board. Hopeman Brothers estimated that direct salary costs for the assignment to be $44,000, plus fringe benefits of 25 percent, and overhead costs of $5,000, for total costs of about $60,000. This included about 11 months of employees' and officers' time and 3 weeks' time for consultations with a public accounting firm over a 4-year period (1972-1976). Hopeman Brothers relied to a great extent on memory to prepare these estimates for the 4-year assignment period.

The largest tasks were: (1) to complete a request for significant detail in March 1974, which Hopeman Brothers estimated took at least 4 weeks; and (2) to prepare "Section 0 - Statement of Factors" which Hopeman Brothers estimated took about 25 days for officers and employees to complete. According to Hopeman Brothers' officials, one employee spent 3 days with a Renegotiation Board auditor during a field visit and three officers spent 1 day with Board personnel during a subsequent visit.

Hopeman Brothers stated that their top management supervises the daily operations of the company. They do not have staff personnel competent to handle renegotiation. Thus, renegotiation increases the burden of their top management, and thereby reduces their effectiveness in running the company. Cost impact of this reduction in supervision, in Hopeman Brothers' opinion, exceeded the direct costs given above.

Hopeman Brothers' estimate of $60,000 includes the assignment of two filings for field review. Renegotiation Board officials told us that assignments are frequently made for 2 or more fiscal years at a time for economy. They said it is not possible to segregate the costs to comply for each year. The Renegotiation Board study treated both assignments as one. Even though the $60,000 was for two assignments, it is Hopeman Brothers' opinion that most of the renegotiation effort went into the FY 1971 filing. Therefore, they believe the cost of assignment for only this 1 year would have been substantially the same figure as for the 2 years.

Basis for Board estimate for Hopeman Brothers

Renegotiation Board personnel informed us that their cost figures for Hopeman Brothers were based on estimates of the amount of time spent complying with Board requirements. This amounted to one person working 2 days on the initial filing and 4 weeks on the assignment process which extended over a 4 year period. The Board's percent figure for fringe benefits was 20 percent higher than Hopeman Brothers. Board personnel stated that they only covered the cost of Hopeman Brothers headquarters filings, and did not include the cost of filings required for Hopeman Brothers subsidiaries.

Conclusion

We reviewed the renegotiation files at Hopeman Brothers and discussed the renegotiation process and their cost estimates with company officials. The level of effort and the resulting costs developed by Hopeman Brothers are estimates which cannot be verified in a precise manner. However, based on a review of available records, we believe the Renegotiation Board's estimate of Hopeman Brothers' costs is understated. The degree to which it is understated cannot be determined.

MARTIN MARIETTA CORPORATION

Martin Marietta Corporation and its affiliates had total sales of about $887 million in the year ending December 31, 1975, of which 31 percent were subject to renegotiation. Martin Marietta Corporation's Aerospace Group had three divisions with renegotiable sales. In addition, Martin Marietta Laboratories, Martin Marietta Aluminum, Inc., and Martin Marietta Aluminum Sales, Inc., had substantial renegotiable sales. Renegotiable sales were primarily for the design, manufacture and testing of missiles, launch vehicles, and other space program items.

Martin Marietta Corporation was included in the Renegotiation Board's analysis of industry costs to comply with renegotiation requirements. We contacted the responsible official at Martin Marietta Corporation to determine whether compliance cost estimates had been developed. We were advised that cost estimates had not been prepared by Martin Marietta Corporation and that estimates could not be prepared for audit within the time frame of our review.

MACHINERY AND ALLIED PRODUCTS INSTITUTE

Statement of the
Machinery and Allied Products Institute
to the
Subcommittee on General Oversight and Investigations
House Committee on Banking, Finance and Urban Affairs
Concerning H.R. 3020
The Proposed War Profiteering Prohibition Act of 1985

- Renegotiation is bad law--inequitable, arbitrary, and capricious
- In view of the incredibly comprehensive system of procurement controls in place, renegotiation is totally unnecessary
- Defense contract profits generally are not unreasonable and reasonable prices should be the governing criterion
- Renegotiation is not cost-effective for the government
- The Congress should concentrate on the many critical issues before it and put aside indefinitely reconsideration of renegotiation

November 12, 1985

MACHINERY AND ALLIED PRODUCTS INSTITUTE

Statement of the
Machinery and Allied Products Institute
to the
Subcommittee on General Oversight and Investigations
House Committee on Banking, Finance and Urban Affairs
Concerning H.R. 3020
The Proposed War Profiteering Prohibition Act of 1985

November 12, 1985

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to present its views to the Subcommittee on General Oversight and Investigations concerning H.R. 3020, the proposed "War Profiteering Prohibition Act of 1985," as introduced by Representative Henry B. Gonzalez (D-TX), a member of the Subcommittee.

We ask that our statement be included in the record of the hearing held by the Subcommittee on October 30. It is our understanding that the hearing may be continued at some future date, in which case MAPI will be prepared to present oral testimony at that time at the call of the Chairman.

As the Subcommittee may know, MAPI represents the capital goods and allied product industries of the United States. In addition to traditional capital goods product lines, MAPI's constituency includes leading companies in the electronics, precision instruments, telecommunications, computer, office systems, aerospace, and similar high-technology industries. Although many of the companies in these industries are predominantly oriented towards the commercial market, a significant number have substantial defense sales at the prime and/or subcontract level and, accordingly, have a particular interest in government contracts. This accounts for their concern with any proposed legislation, such as H.R. 3020, which might adversely affect contractors in their relationship with the government and, indeed, impact the public interest.

The Broader Issue: Improvements in the Acquisition Process

Before proceeding with our comments on renegotiation, it should be recognized that during the hearing of the Subcommittee on October 30 Congressman Steve Bartlett (R-TX) indicated that, in his view, rather than just denouncing a system so universally discredited as renegotiation, a genuine contribution to the hearings could be made by addressing how Congress could improve the acquisition process and how DOD could improve its management of the system. By coincidence, MAPI testified on November 7 before the Senate Armed Services Subcommittee on Defense Acquisition Policy. We addressed both questions referred to by Congressman Bartlett and attach as a part of our total presentation to your Subcommittee a copy of our statement to the Quayle Subcommittee.

Introductory Comments
on Renegotiation

H.R. 3020 would (1) restore the Renegotiation Act by making the renegotiation process effective as of the date of enactment of the bill and through September 30, 1988; (2) raise the floor from $1 million to $5 million on annual renegotiable sales subject to renegotiation; and (3) require that renegotiation be conducted by division and major product line rather than on an overall basis as had been the case.

MAPI strongly opposes H.R. 3020, and urges its rejection by the Subcommittee.

Our objections to the bill go beyond its specific provisions to fundamental issues: (1) Is there a need for statutory authorization of renegotiation of defense contractor profits at the present time? and (2) Based on experience with the process of renegotiation, is it an appropriate device in terms of equity and due process, and in respect to cost to the government?

Subject to elaboration later in this statement, it is our view that there is no need for an additional control mechanism in the procurement area; more specifically, there is no justification for reinstating the renegotiation process. We believe our judgment is widely shared in government and in the private sector, as documented by the hearing of this Subcommittee on October 30, 1985.

With respect to the second issue, in our opinion, renegotiation is and always has been bad law because it permits the taking of private property on the basis of largely subjective judgments. It has been quite accurately characterized as taxation without a rate book, which evaluation we believe was first made by the distinguished elder Senator Robert A. Taft. Moreover, we think that any attempt to draw more definitive statutory factors or guidelines for the determination of "excessive" profits will fail because of the inherent defects of the renegotiation process.

In dealing philosophically with the concept of renegotiation, there are certain observations that should be made beyond its inherent arbitrary and capricious nature. What is "excessive"? In raising this question we underline the arbitrary nature of the process. It is also fair to turn the coin over and ask whether, if the government recaptures "excessive" profits, it should compensate for "inadequate" profits. There is also the question as to whether the issue really is the level of profits rather than the achievement of a reasonable price by the various mechanisms which the government employs to that end. In other words, if the government obtains through the contracting process a quality product, with timely delivery, and at a reasonable price, isn't that all that the government should ask, without examining into profit levels? Carrying this concept one step further, the process of renegotiation for so-called—but almost indefinable—"excessive" profits punishes the efficient contractor and blunts the incentive to produce and deliver a quality product at a reasonable price. See the testimony on October 30 by Richard G. Mulligan, Vice President, Financial Control, of TRW Inc., who appeared before this Subcommittee in behalf of the Financial Executives Institute.

Further, the previous legislative record on renegotiation contains substantial evidence that the cost of renegotiation exceeds the proceeds from refunds directed by the Renegotiation Board.

A statement of these two basic issues leads us to the following conclusions:

1. Existing statutory provisions and procurement techniques, properly administered, protect the public interest with respect to profits on defense contracts.
2. The recently completed Defense Financial and Investment Review (DFAIR) study indicates that realized profits on defense business are, in fact, not unreasonable.
3. The claim by its proponents that renegotiation adds money to the federal treasury is inaccurate.
4. Congress has given careful consideration to proposals to continue renegotiation and/or other profit limitations on defense contracts on several occasions in the past ten years and, each time, has rejected such proposals.

Our views on these points are spelled out below.

Existing Statutory Provisions and Procurement Techniques

A forceful statement as to the lack of need for renegotiation was that made on behalf of the Department of Defense by the then Deputy Under Secretary of Defense (Acquisition Management) at the Subcommittee's hearing on this issue on March 21, 1984./1 The Deputy Under Secretary noted, " . . . there are a number of laws, several well established procedures and a professionally well qualified workforce which essentially assure that excessive profits do not occur." The following statutes and procedures, which have come into existence since the original enactment of the Renegotiation Act in 1951, were cited in that testimony:

1. Public Law 87-653, the "Truth in Negotiations Act" (which provides the government a mechanism to unilaterally reduce a contract price if certified cost or pricing data provided by the contractor is shown subsequently to have been noncurrent, inaccurate, or incomplete);
2. Cost accounting standards;
3. Cost allowability rules in procurement regulations;

1/ Oversight Hearing on Profits on Defense Contracts, Serial No. 98-75, March 21, 1984, p. 50.

4. The role of the Defense Contract Audit Agency (DCAA);
5. Comptroller General audits;
6. Anti-fraud statutes;
7. The Anti-Kickback Act;
8. The Anti-Gratuity statute; and
9. The policy against contingent fees.

Each of these items was discussed in some detail in that testimony; hence, we do not elaborate here.

It should be pointed out, however, that on this occasion the DOD "acquisition management" point of view on renegotiation was strongly supported by Derek J. Vander Schaaf, the DOD Deputy Inspector General, who stated that " . . . I would not be in favor of reestablishing some sort of renegotiation process within the Federal Government at this time."/1

It seems to us that the Deputy Inspector General's testimony may be of particular significance because the record in recent years clearly indicates the independence of the DOD Inspector General's office from the DOD acquisition management operation. Certainly, both Mr. Vander Schaaf and his superior, Inspector General Sherick, have been quite vocal in the past in stating any disagreement that they might have with other senior DOD officials on audits, pricing, and other aspects of procurement policy.

Beyond the statutes and procedures referred to in the testimony cited above, the Congress has enacted the Competition in Contracting Act, the Defense Procurement Reform Act of 1984, and the Small Business and Federal Procurement Competition Enhancement Act of 1984. The Subcommittee is also familiar, we are sure, with the sweeping procurement policy changes contained in the conference version of the fiscal year 1986 Defense Authorization Act. Although we have some problems with these new laws, it is clear that all of these statutes were intended by the Congress to protect the public interest in reference to the acquisition process. Moreover, in what is called the Anti-Fraud Enforcement Initiative package of bills, the Reagan Administration has made additional recommendations to the Congress to reform the procurement process and reinforce the government's efforts to prevent fraud, waste, and abuse in federal programs. All of these developments support the conclusion that government controls in the acquisition process are wide sweeping, if not excessive, and the process will undoubtedly go forward without the need for reactivating an obsolete and inherently defective process such as renegotiation. This proposition was emphasized by Eleanor R. Spector, Deputy Assistant Secretary of Defense for Procurement, in her statement to this Subcommittee on October 30, 1985.

1/ Ibid., p. 129.

One caveat is appropriate in respect to this array of government controls in the procurement area. A strong case can be made for the proposition that the control process has already gone too far, that Congress is engaged in micromanagement of the procurement system, and that, if the trend continues, the defense product, which is the ultimate objective of the procurement system, will suffer. But that is a story for another day and another forum, although it does have some relevance to the renegotiation issue.

The elaborate system of "management improvement initiatives" being undertaken in the Department of Defense should also be recognized. Here DOD, as shown in a report dated June 17, 1985, is making substantial improvements in controlling cost growth. In the June 17 report the data indicate that in base year dollars the annual rate of cost growth for selected major acquisition programs (excluding economic and quantity changes) has dropped from a high of about 8 percent in 1981 to a low of less than 1 percent in 1984. In current or then-year dollars, the annual rate of growth has dropped from a high of about 14 percent in 1980 to a low of less than 1 percent in 1984. In this effort the DOD is improving the acquisition process "up front" by controlling costs in the procurement stream, which is a much sounder approach than examining profits after the fact through such a clumsy and inequitable device as renegotiation.

The DFAIR Study

Proponents of the reinstitution of renegotiation have indicated their belief that there may well be "excessive" profits in defense business, and they feel that demonstrates the need to reestablish the renegotiation process. We think that evidence now available is definitely to the contrary. The Defense Financial and Investment Review (DFAIR) study was made public this summer, and we think that its pertinent conclusions on this issue are of sufficient importance as to warrant their being included in full text at this point./1

> Profitability of defense contracts has not been unreasonable. Several comparisons were made with results of selected durable goods manufacturers over the period of 1970-1983. Before interest and before tax return on sales and return on assets ratios included an adjustment for the value of government-provided financing on defense contracts. This adjustment significantly increased the profitability of defense work. Additionally, an economic profit-to-sales measure was used to determine an after interest before tax return on sales. This measure of profitability imputes an interest expense as a surrogate for the opportunity cost of financing inventory or fixed assets. The value of government-provided financing is also considered by this measure.

1/ Defense Financial and Investment Review, Department of Defense, June 1985, pp. IX-3 and IX-4.

Defense economic profits were very similar to those of comparable durable goods manufacturers for the years 1970 through 1979, and for the period of 1980 through 1983. The average defense profitability decreased slightly from the previous 10-year period while that of durable goods manufacturers deteriorated dramatically. There are a number of reasons for this result.

- The durable goods profits during 1980 to 1983 are depressed due to the most severe recession in 50 years and are significantly below the average experienced during the 1970's.
- Defense profits have not fallen as much as those of durable goods manufacturers during this period due to the increase in outlays associated with the defense buildup and the decline in inflation. The latter point undoubtedly had an impact on this result since contracts priced in 1979-1980 may have been based on an inflation forecast error which affects profit outcome to some unknown, but positive degree.

In comparison with commercial work in the same product groups during 1981-1983, defense profits were somewhat higher overall. However, this was due entirely to the aircraft and shipbuilding product groups, who were experiencing extremely low demand in commercial aviation and shipbuilding. Other product groups performed equally well or better on commercial work in comparison with defense.

DFAIR comments on renegotiation.--The following comments on renegotiation in the DFAIR study emphasize the fact that the views of DOD on the subject have not changed since the March 1984 DOD testimony at the Subcommittee hearing:/1

Renegotiation

Renegotiation, under the 1951 Renegotiation Act, was a procedure to identify and recover excess profits earned on individual defense contracts. Congress allowed the Renegotiation Act to expire due to evidence that it imposed a costly administrative burden on reporting firms, tended to direct its efforts toward smaller contractors, and was no longer needed. Legislation is periodically proposed to reinstate renegotiation, usually with some consideration given to minimizing administrative costs.

1/ Ibid., pp. V-4 and V-5.

The DoD position has been that the best approach to avoiding excess profits is good pricing. Given an adequate number of well-trained contracting officers with supporting field auditors and pricing personnel, and with the protection provided by the Truth in Negotiations Act and fraud statutes, there is no reason why excess profits should be a significant problem. Cost accounting standards have superseded the allocation disputes which were the heart of many of the Renegotiation Board's findings of excess profits. Finally, good pricing has the advantage of encouraging cost control, because a contractor must underrun tight costs to earn a high profit. The renegotiation approach, on the other hand, would tend to encourage contractors to attempt to increase costs on profitable contracts, rather than to cut costs still further.

Renegotiation might be a cost-effective approach if overpricing were pervasive; otherwise, the arguments in favor of good pricing and case-by-case defective pricing procedures appear conclusive. The evidence available to DFAIR which would indicate whether pervasive overpricing exists is a comparison of negotiated markup to earned profit. If earned profits have been significantly higher than negotiated markups, this could point to an overpricing problem. If this comparison shows that earned profits have been conforming to the negotiated results, but are still too high, the solution would not be renegotiation but a change in markup policy.

DFAIR found aggregate earned profit margins to be consistently lower than aggregate WGL expectations. The one noteworthy exception to the trend of below-expectation profit margins is in the shipbuilding industry; even there, profits are higher than expected only on cost-type contracts. These results, discussed at more length later in this chapter, support the DoD position that renegotiation is not needed.

The Cost of Renegotiation

Although we believe the congressional decision respecting reinstitution of renegotiation should turn on the merits of the Act--its fundamental characteristics--Renegotiation Board figures concerning the recapture of "excessive" profits and the indirect prevention of such profits have been used by the Act's proponents to justify its continuance on pragmatic grounds. A comparison of figures in the Renegotiation Board's annual reports for the period 1969-78, the last ten years that the renegotiation process was in existence, might lead the uninformed or the unwary to believe that renegotiation is a paying proposition from the government's standpoint. Let us set the record straight.

In its final report for fiscal 1978, the Renegotiation Board made 37 determinations of "excessive" profits totaling $31.5 million which, after allowance for federal and state taxes, was reduced to $18.2 million. At first blush these figures appear to suggest a good bargain for the taxpayer.

Such figures as appear in the annual reports of the Board, however, obscure completely the very substantial cost to industry of complying with the Act and the whole of which is tax deductible. Unfortunately, there are no firm and absolutely verifiable figures on the cost of industry's compliance. However, our continuing study of the problem over the life of the Act, including repeated discussions of the matter with individual companies, convinces us that a figure of 1/10 of 1 percent of total renegotiable sales represents a conservative estimate of this cost. Accepting this factor as a reasonable measure of industry's cost of administration, let us apply it to the last ten years of renegotiation and then see what kind of bargain the taxpayer actually has. Renegotiable sales during fiscal years 1969-78, inclusive, amounted to $372.5 billion from which we may deduce a cost of administration approximating $372.5 million. Expenses of the Renegotiation Board during the same period amount to $50.4 million which brings us to a total cost figure of $422.9 million. During the same ten-year period, "excessive" profits determinations (after tax) of the Renegotiation Board amounted to $198.4 million, leaving us with a net deficit for the period of $224.5 million.

Thus, there is a very substantial cost properly attributable to the renegotiation process, and that cost should be recognized in any deliberations on reinstatement of renegotiation.

Congressional Consideration of Renegotiation and/or Other Profit Limitations on Defense Contracts

Congress has dealt with this issue on several occasions during the past ten years, following the general oversight hearings conducted by this Subcommittee in June 1975 under former Congressman Minish, who previously chaired the Subcommittee. Legislation sponsored by Mr. Minish to extend the Renegotiation Act beyond its then-scheduled termination date of September 30, 1976, failed of enactment in both the 94th Congress (ending in 1976) and in the 95th Congress (ending in 1978). The unwillingness of Congress to extend the Renegotiation Act any further was followed by its decision to fund the Renegotiation Board only through March 31, 1979. The Renegotiation Board terminated its operations as of that date.

As a result of the lapse of the Renegotiation Act, the Vinson-Trammell Act provisions imposing profit limitations on contractors for naval shipbuilding and military aircraft automatically became applicable to the post-September 30, 1976 period. After careful consideration of the matter, including hearings by the House Armed Services Subcommittee on Procurement and Military Nuclear Systems, the Fiscal Year 1982 Defense Authorization bill, enacted on December 1, 1981 (P.L. 97-86), repealed the Vinson-Trammell Act profit limitation provisions. As a substitute for these provisions, the President now is authorized, upon a declaration of war or national emergency, to prescribe such regulations to control "excessive" profits on defense contractors as he determines are necessary during such period.

Thus, on each of these occasions the Congress has had to consider the continuation of renegotiation and/or other profit limitations on defense contractors in peacetime and has declined to continue such controls. In our view, the situation with respect to this issue has not changed, and we urge that defense contractor profit controls again be rejected.

Comments on Specific Provisions of H.R. 3020

We have relegated to brief treatment at the end of this statement comments on specific provisions of the legislative proposal before the Subcommittee because of our fundamental objection to the renegotiation concept and process and the suggested reinstatement of the law.

H.R. 3020 would require that renegotiation be conducted by division and product line rather than on an overall basis which had been the case when the Renegotiation Act had been in effect. One element of renegotiation which had merit during its previous applicability was the concept of overall evaluation of profits derived from renegotiable contracts. This was based on the theory that relatively high profits on one contract or series of contracts should be balanced against inadequate profits or losses on other contracts. Renegotiation by product line, by division, or by individual contract vitiates this theory and element of fairness. There is absolutely no justification for such an approach to renegotiation. See the testimony on October 30 by Donald S. Grenough, Partner, Touche Ross & Company.

Conclusion

In summary, without qualification, we oppose the reinstitution of the renegotiation process. Renegotiation is bad law—inequitable, arbitrary, and capricious. With respect to defense contractor profits, the Congress and procurement authorities have developed an incredibly comprehensive system of procurement requirements so that contemplating reinstatement of renegotiation is redundant. The available evidence indicates that defense contract profits generally are not unreasonable, and reasonable prices should be the governing criterion in any event. On four separate occasions in the past ten years the Congress has considered and rejected the continuation of renegotiation. Finally, the renegotiation process is not cost-effective from the government's standpoint.

Respectfully we suggest that a Congress which has so many critical issues and legislative proposals on its agenda can, in good conscience, put aside this proposal for reinstatement of renegotiation, which has no merit whatsoever.

MACHINERY AND ALLIED PRODUCTS INSTITUTE

Statement of the
Machinery and Allied Products Institute
to the
Defense Acquisition Policy Subcommittee
Senate Armed Services Committee
on
Recent Procurement Legislation and Its Implementation

- Absence of Recognition of the Extraordinary Technological Achievements of Defense Industry
- Proliferating Procurement Legislation
- Micromanagement of the Acquisition Process by Congress
- Overregulation of Contractors by Procurement Authorities
- Failure To Reconcile Conflicting Procurement Objectives
- Excessive Criticism of Defense Industry, Inflamed by the Media
- Ultimate Risk Is Establishing a Direction Toward Nationalization of Defense Industry Base

Presented by
Charles W. Stewart, MAPI President

November 7, 1985

MACHINERY AND ALLIED PRODUCTS INSTITUTE

Oral Comments
by
Charles W. Stewart, President,
Machinery and Allied Products Institute
to the
Defense Acquisition Policy Subcommittee
Senate Armed Services Committee
on
Recent Procurement Legislation and Its Implementation

November 7, 1985

It is a privilege for MAPI to appear. I am accompanied by William Healey, MAPI Vice President-Law.

Within the limited time for oral comment, I can only hit the high spots of our statement, the full text of which we ask be included in the formal record of these proceedings. As you will observe, the specific comments in our statement are keyed for the most part to the testimony of Assistant Secretary Wade of the Department of Defense before this Subcommittee on October 17.

I should like to emphasize the following points offered in our presentation:

1. In our view it is important for Congress to resist further procurement legislation and for DOD to curb further expansion of administrative controls. Within the last two years the Congress has been generating new legislation at an incredible rate. As long as these new laws remain on the statute books, they must be implemented by regulations and directives and lived with by both procurement authorities and defense contractors. This is an enormous task. I am told that it takes three to five years to institutionalize major changes in law.

   In this connection, when the Defense Appropriations bill goes to conference, I trust that the Senate will block further procurement changes included in the House-passed bill.

2. We feel that it is incumbent on the Congress, and to some extent on the Department of Defense as well, to build a comprehensive record of defense industry technological accomplishments, which are extraordinary. At page 2 of our statement we identify certain examples at random: The performance of the shuttle and its role in commercial and defense activities have almost been overlooked in the rhetoric. This is a remarkable achievement and it is being taken for granted. The B-1B record in terms of

technological accomplishment and delivery on schedule is outstanding. The recent intercept by Navy fighter aircraft in the Mediterranean was accomplished with the application of extraordinary technology and military performance and yet the Congress, and particularly the media, apparently would rather talk about so-called horror stories. Much of the same can be said for contributions in the missiles area, e.g., the Patriot and the Titan. The M2/3 Bradley Fighting Vehicle is another example of leading and vital technology. And we should not overlook the classified and critical contributions of defense industry to the Defense Advanced Research Projects Agency (DARPA) and to the Strategic Defense Initiative (SDI). Further, don't overlook the contribution of thousands of subcontractors to such programs. In connection with the availability of such information, attention is called to the publication of the Association of the United States Army (1985 Edition) entitled "Issues Impacting on the Land Forces of the United States."

On the House floor on October 30, Congressman Miller of Ohio made the same point, referring particularly to the B1-B.

3. Through law and administration a number of acquisition priorities have been developed and placed in effect. There are certain inherent conflicts between these priorities and, in our opinion, it is the obligation of the Congress and the procurement authorities to identify these conflicts and reconcile the priorities. Otherwise, the will of the Congress and the intent of the procurement authorities in an overall sense will be thwarted and we will confront at least to some extent the danger of chaos. I refer here to such priorities as competition, quality, incentives for utilization of advanced technology in production, protection of proprietary rights, maintenance of an adequate industrial base, etc.

4. Oversight by the Congress and participation in the legislative process involving procurement legislation is grossly overdone in terms of the number of committees, subcommittees, hearings, reports and, if I may use the word, inquisitions, which are involved. As a long-time observer of the congressional and executive branch scene, I don't know how the legislative process in respect to procurement policy can operate effectively under these conditions. And the implementation burden placed upon the procurement authorities is unbelievable and unsustainable, in my opinion. The Congress should undertake a narrowing of the role of oversight and committee activity in legislation insofar as the procurement policy area is concerned. This, of course, will require a balancing of congressional deference and organizational discipline. We have entirely too many committees, subcommittees, staffs, and individuals in the act.

5. The Congress is appropriately concerned with cost in the procurement area, but it stops short of examining a key element of cost. I refer to the proliferating cost of control and regulation. This is a real challenge to the Congress and to the procurement authorities to quantify. In my opinion, a careful examination of the cost of control and regulation will justify limiting further expansion of controls and regulations and may very well trigger some reduction in the control apparatus. In this measurement process, special attention should be given to the exploding cost of the audit function. And in examining cost, direct cost should, of course, be determined, but indirect cost impacting on the contracting process and the weapon production effort should also be examined. I refer here to bogging down of defense production, diversion of contracting personnel—both government and industry—from such objectives as quality, etc.

   Dr. Edward Luttwak, Georgetown University, and Dr. Gansler of The Analytic Sciences Corporation, speakers at a very recent conference of NCMA, said that perfection in the procurement process, including total competition, is not cost-effective. Dr. Luttwak thinks that it was a waste of money for the Air Force Systems Command to add 3,000 people to deal with the acquisition of spare parts. Those 3,000 people cost a lot more than the overpriced portion of spare parts. Both agreed that there will always be some mistakes because it is not cost-effective to be perfect, even if this were possible. Harvey Gordon, Director, Business Government Policy, Martin Marietta Corporation, stated it best when he said there must be a meaningful distinction between doing a job well and doing it perfectly.

6. The Congress and the procurement authorities should undertake a joint investigation of the relationships between project managers, contracting officers, and auditors. It has become deliberate policy to give overriding authority to the auditing function with the result that the project manager, and the contracting officer in particular, are relegated to lesser roles and deprived of certain incentives which are necessary to achieve the best result.

   With respect to the degradation of the authority of the contracting officer, William W. Thurman, Deputy Director, National Security Division, General Accounting Office, said at the recent NCMA conference that GAO performed a one and one-half year study (to be released shortly) of the career path of government program managers and contracting officers and found evidence of micromanagement. Decisions are being made at the secretariat level in the military services instead of by the program managers and contracting officer. Also, whatever decisions the program manager and contracting officer are allowed to make are scrutinized by a plethora of checkers, such as competition advocates and streamline advocates mandated by the procurement reform legislation. Professor Cibinic, also a speaker, went so far as to say that the contracting officer is a legal fiction. John D. Rittenhouse, Executive Vice President, RCA Aerospace and Defense, agreed with this, and added that it is hard for a contractor to know who is in charge because the program manager and contracting officer frequently have to check with superiors. He has reiterated this position in his panel presentation today before the Subcommittee.

Darleen Druyun, government's procurement expert on technical data and Principal Assistant Deputy Chief of Staff for Contracting, Air Force Systems Command, said at the same NCMA conference that the quality of contract work performed by government procurement personnel has declined. She attributes this decline to several factors, including (1) the 30 percent change in the procurement regulations since the FAR was implemented on April 1, 1984, which was primarily due to the three 1984 statutes (it takes three to five years to institutionalize changes); (2) the increased complexity of contracting due to the three statutes; (3) the degraded authority of the contracting officer (e.g., DCAA has been granted authority to negotiate all final indirect cost rates at contractor plants); (4) constant negative publicity; (5) a significant workload increase without a proportionate increase in contracting personnel (30 percent increase in contract actions from 1983 to 1985); (6) the goldfish-bowl environment in which contracting people work (one Air Force Plant Representative Office (AFPRO) which employs about 100 persons had an average of 400 visitors a month).

7. The Congress should also examine into what appears to be the development of certain autonomous procurement postures and actions by individual services. The corollary to that proposition is that there is some evidence that the Department of Defense at the OSD level is not monitoring this problem adequately and is not exercising sufficient centralized control over the services. We need a single set of procurement policies, not a multiple set.

   In this connection, I call the attention of the Subcommittee to the memorandum to the Secretary of the Navy from the Deputy Secretary of Defense dated October 25, 1985, in which the Deputy Secretary requests the Secretary of the Navy ". . . to direct the Assistant Secretary of the Navy (Shipbuilding and Logistics) to withdraw the memorandum" previously issued by the Navy on per diem costs allocable to DOD contracts. The Deputy Secretary went on to say: "In addition, you should advise him that in the future, he should follow the necessary appropriate procedures in order to avoid a recurrence of this type of situation." The free-wheeling by the Navy is an illustration of my point, and I am pleased in this case that OSD moved in on the situation. They should do so more often.

8. I call attention to our comments on proprietary data and the importance of maintaining a sound and strong defense industrial base at the prime, subcontractor, and sub-subcontractor levels. Don't tolerate blunting of contractor incentives by unwarranted taking of proprietary data.

9. Comments on implementation of the three major procurement statutes enacted in 1984 must be preliminary in nature because the implementation process is by no means complete and because of deferred effective dates contained in the legislation; even when the statutes are implemented, the impact has been postponed to some degree.

In submitting our full statement for the record and in an effort to summarize it within your time schedule, I want to emphasize that MAPI and I personally are very conscious of the responsibilities of the contracting community at large and individual contractors at all levels to take an ethical approach to their contracting roles; to apply to the maximum extent possible internal controls; to abide by the law and regulations; and, above all, to make maximum contribution to the ultimate objective of the acquisition process which is to furnish the highest quality product possible at a reasonable price and with timely delivery.

It is only against this background that I have presumed, with due respect to the Subcommittee, to make suggestions regarding some studies that might be undertaken by government and to offer criticisms which we feel are constructive and in the public interest. To add a word, we recognize the duty of the private sector active in the defense acquisition process to respond affirmatively to well-founded criticisms of performance.

Statement of the
Machinery and Allied Products Institute
to the
Defense Acquisition Policy Subcommittee
Senate Armed Services Committee
on
Recent Procurement Legislation and Its Implementation

November 7, 1985

Introduction

We appreciate the opportunity to discuss, at least in a preliminary manner, the legislation enacted last year on procurement and the status of its implementation. More specifically, the Subcommittee seeks comments on implementation of the Competition in Contracting Act, the Defense Procurement Reform Act of 1984, and the Small Business and Federal Procurement Competition Enhancement Act of 1984. I indicate that we will comment in a preliminary manner because the implementation process is by no means complete and, because of deferred effective dates contained in the legislation, the impact even when the statutes are implemented has been postponed to some degree. In addition, for other reasons, it is a little early to obtain constructive reactions from industry on the effects of the legislation.

First, a word about MAPI. As the Subcommittee may know, MAPI represents the capital goods and allied product industries of the United States. In addition to traditional capital goods product lines, MAPI's constituency includes leading companies in the electronics, precision instruments, telecommunications, computer, office systems, aerospace, and similar high-technology industries. Although many of the companies in these industries are predominantly oriented towards the commercial market, a significant number have substantial defense sales at the prime and/or subcontract level and, accordingly, have a particular interest in government contracts. This accounts for their concern with any legislation which might adversely affect contractors in their relationship with the government and, indeed, impact the public interest adversely.

I should add that we must be especially sensitive to the problems at the subcontracting level, which too often are overlooked or given only limited consideration.

Extraordinary Contribution to National Security by Defense Industry: Need for Public Recognition by the Congress and Procurement Authorities

The Congress and procurement authorities have become so preoccupied with enacting in statutory form and promulgating administratively controls and regulations on defense industry that the critical role of contractors in innovation and production of sophisticated, complex, and absolutely critical defense products is being subordinated.

Let me cite at random a few examples. The performance of the shuttle and its role in commercial and defense activities have almost been overlooked in the rhetoric. This is a remarkable achievement and it is being taken for granted. The B-1B record in terms of technological accomplishment and delivery on schedule is outstanding. The recent intercept by Navy fighter aircraft in the Mediterranean was accomplished with the application of extraordinary technology and military performance and yet the Congress, and particularly the media, apparently would rather talk about so-called horror stories. Much of the same can be said for contributions in the missiles area, e.g., the Patriot and the Titan. The M2/3 Bradley Fighting Vehicle is another example of leading and vital technology. And we should not overlook the classified and critical contributions of defense industry to the Defense Advanced Research Projects Agency (DARPA) and to the Strategic Defense Initiative (SDI). Further, don't overlook the contribution of thousands of subcontractors to such programs. In connection with the availability of such information, attention is called to the publication of the Association of the United States Army (1985 Edition) entitled "Issues Impacting on the Land Forces of the United States." MAPI hopes to develop this aspect more fully in oral testimony, but it is emphasized here preliminarily.

Let me carry the point one step further. Why shouldn't this Subcommittee call a hearing on the technological achievements jointly accomplished by defense industry and procurement authorities? The American people are entitled to this information and to a balancing of the record. If you pursue this suggestion, I recommend that you issue a report rather than depending on the media to report results.

Specific Comments Keyed to Testimony of DOD Assistant Secretary Wade

Our statement uses as a launching base the testimony of The Honorable James P. Wade, Jr., Assistant Secretary of Defense (Acquisition and Logistics) before this Subcommittee on October 17. Proceeding in this manner, we will quote from Assistant Secretary Wade and then offer pertinent MAPI comments at each juncture. The material taken from Assistant Secretary Wade's presentation is indented in quotations; then our observations follow each quotation.

Need for caution in adopting new statutory rules.—

> ". . . While we would have preferred to perfect the procurement system, including manpower, requirements, quality and process through regulatory reform, we are pursuing the course of action that Congress has laid out. . . ."
>
> "However, we must be cautious about laying down statutory rules that may inhibit our flexibility to take advantage of research and technology advances. . . ."

With one exception, we agree with both observations of Assistant Secretary Wade. In our judgment, Congress has over-legislated in the procurement area within the last two years and is practicing what has been commonly called "micromanagement" of the acquisition process. This will eventually bog down the essential role of acquisition which is to procure a high-quality product in timely fashion and at a reasonable cost. The risk from excessive control of the system is that the United States will be buying more controls and less product.

The regulatory process and its impact are very costly and the Congress would be well advised to attempt to measure the cost of regulation in this area. I think you would be surprised by what you find.

The exception to which I refer is that excessive control and over-regulation can be invoked administratively by the Department of Defense in the same way that Congress might over-legislate. And it is our feeling that the Department of Defense is moving in the direction of excessive control on its own initiative. A current example of administrative overreaching is the proposed regulation on technical data to which I will refer in more detail later; another illustration is the DOD Certificate on Overhead Cost which was a classic example of bad draftsmanship and regulatory abuse.

Let me dramatize the proposition of overregulation and micromanagement. The trend is so strong in statutory enactment and in the philosophy and content of administrative regulation by procurement authorities that we may be on the road to the equivalent of nationalization of defense industry. It would be premature and extreme to conclude that we have reached that result but the direction is clear. And believe me government is in the very risky business of pushing in that direction and yet having no responsibility for the end-product in terms of procurement results. Let us all ponder this suggestion of direction.

In this connection, I draw the Subcommittee's attention to the interchange between Senator Quayle and Assistant Secretary Wade during the question period following his testimony on October 17. Assistant Secretary Wade backed off from the view expressed in his principal testimony that Congress was over-legislating in the procurement area and that so much legislation might create a "rupture" in the acquisition process. I think this deviation from Mr. Wade's principal testimony was unfortunate, whether or not inadvertent. Not only has there been too much legislation, its detailed nature compounds the problem.

The Competition in Contracting Act and the role of competition generally.—

> "The Competition in Contracting Act of 1984 (CICA) has received the most attention in and outside the government since its provisions are applicable to all government agencies. . . . The real impact of this Act will occur in FY 1986 as a large number of solicitations for major programs were issued before April 1, 1985 and thus the Act did not apply. . . . Our objective is to pay a fair and reasonable price for quality supplies and services. Competition is one method for achieving that objective where it is practicable and possible."

As Assistant Secretary Wade points out, measurement of the real impact of this Act must be deferred because of the effective date. Some preliminary observations, however, seem to be in order. The recognition in the new law that negotiation can be competitive is a step forward. Sealed bidding has no monopoly on competition and is inappropriate in many procurement situations.

Having said that, it is important for the Congress and procurement authorities to recognize that fair and reasonable contract pricing is the basic objective, and competition is merely one method of achieving that objective. Competition should not be forced into the process where, as Assistant Secretary Wade indicates, it is not practicable or possible. Achievement of competition in certain situations can be very costly and not productive. The process of "creating" a competitor from scratch may not work and, even if it does, may be very expensive. In a way, striving for competition in government procurement runs the risk of attempting to transfer a commercial concept widely practiced with success in the commercial world but not always appropriate to government procurement, particularly when you are dealing with advanced and very complex systems.

Attempts to achieve greater competition also may cause conflicts with other procurement criteria and objectives. To illustrate, to achieve greater competition the procurement system should not sacrifice quality of product. Nor should it jeopardize unfairly proprietary rights of a contractor who has brought initiative and innovation to the procurement process.

Further, competition requirements frequently are driven by socioeconomic objectives which, although meritorious in general, often are not conducive to sound procurement policy.

Contractor rights in data.—

> ". . . [C]overage concerning technical data requires careful balancing of the need to acquire the rights in technical data for the purpose of enhancing competition while not stifling the initiative of American industry to develop leading edge technologies without government funding."

The Assistant Secretary is right on target with this statement. But he goes on to acknowledge that critics of DOD's proposed rule on acquisition of technical data:

> ". . . believe that we went beyond the statutory language of what is realistically do-able. Upon reflection, we agree with the sense of the reaction and will revise our implementation to be in accord with the statutory provisions."

This is an example of the draftsmen at the DOD overreaching, as previously indicated. In this connection, the handling of this matter was at a high level in the Department of Defense. MAPI comments to the Department of Defense on the proposed rule are attached as Appendix A to this statement. Moreover, MAPI's representations to the Pentagon on this issue took place over an extended period prior to our comments on the proposed rule.

The validation-of-restrictions regulations raise problems because they would permit contractor restrictive markings to be canceled prior to the final disposition of litigation, if the government finds that "urgent and compelling" circumstances will not permit awaiting the end of the litigation. DOD and the services seem to determine with relative ease that such circumstances exist.

Beyond the question of implementation of the statutory provisions, it is our view that the law itself may be defective in certain respects, and we encourage the Subcommittee to reexamine it. Most importantly, on this point there is the issue of the "cap"--the term of years after which the government would have the right to use contractor data without restrictions. It would seem that if there is to be such a cap, the statute should include a detailed statement of criteria governing its use.

Absorption of new statutory provisions could bog down procurement.—

> ". . . It is a most difficult task for our procurement personnel to absorb these wide-scoped changes and yet continue to purchase supplies and services to clothe, feed, house, train, and provide weapons to our field forces. I am somewhat amazed that there has not been a major rupture in the acquisition process. . . ."
>
> "I would strongly recommend to the committee that it resist further procurement reform legislation until we have had a year or two to assess the impact, improvements, and deficiencies of the legislation enacted. The pending DOD authorization bill for FY 1986 contains a number of additional procurement reforms. I think this is unfortunate. . . ."

The Assistant Secretary makes a valid point. Not only does the authorization bill for FY 1986 contain a number of additional procurement reforms, but the Reagan Administration has now submitted to the Congress another package of legislative recommendations in the procurement area which it calls the "Anti-Fraud Enforcement Initiative" legislative package. There is just too much legislation in the procurement area and, secondly, the Congress does not seem to appreciate fully the implementation burden which this stream of legislative enactments imposes.

"Horror stories" not indicative of procurement as a whole.—

> "I believe the vast majority of the current legislation is based on the premise that the DOD needs assistance in reforming the way we purchase systems, equipment, and materiel. The impetus for many of these reforms has been the seemingly daily 'horror stories' on hammers, coffee pots, or other spare parts. Whether they are individually justified or not, these stories fortunately are not indicative of our current acquisition system as a whole. A sense of proportion, as I alluded to earlier, is lacking."

We agree with the spirit of these comments, although in no way does MAPI wish to challenge the oversight authority and responsibility of the Congress and its cognizant committees. A sense of "proportion," to which Assistant Secretary Wade refers, certainly needs to be applied.

Quality as a goal.—

> "Quality is on the top of my agenda for the future. . . . This concept of minimal quality must be replaced with a philosophy of continuous quality improvement. In DOD acquisition, competition is too frequently based just on price, and an 'award to the low bidder' mentality is too pervasive. As long as this persists, there is no reason for contractors to make quality improvement a way of life. . . . We plan to move away from defining equipment requirements in minimally acceptable terms to a system whereby the best quality equipment at an acceptable price is our recognized objective."

Note the reference to competition too frequently being based just on price.

I am sure that defense industry will cooperate in every way possible with the goals laid down by the Assistant Secretary in reference to quality and achievement of high-quality performance. But both the Congress and procurement authorities must recognize that certain objectives espoused by the Congress and to some extent the procurement authorities, such as an apparent attempt to achieve competition as an absolute goal, are not necessarily consistent with the realization of high-quality performance. To illustrate further, the explosive growth of the audit process interferes with concentration of the contractors on innovation, production, and on-time delivery of quality products. Moreover, overregulation of the defense industry in general is not conducive to maximizing high-quality performance.

With respect to quality, this is a goal that is exceedingly important in commercial business as well as in defense production. I refer the Subcommittee to the new book, The Wall Street Journal on Management/1, in particular to the article entitled "Improving Quality: Lessons From Hewlett-Packard" by John A. Young, President and Chief Executive Officer of that company.

Role of DOD in promoting manufacturing and productivity improvement.—

> "Perhaps most significantly, with an annual procurement budget in excess of $100 billion, the DOD is playing a leading national role in promoting manufacturing and productivity improvement important to the economic revitalization of our nation."

Once again, I feel that defense industry will cooperate in every way possible in the achievement of this objective. On the other hand, it is fair to ask that both the Congress and the procurement authorities examine each procurement technique, policy, and control to determine if it hinders or contributes to the role

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1/ The Wall Street Journal on Management: The Best of the Manager's Journal, Edited by David Asman and Adam Meyerson, Dow Jones and Company, Inc., 1985, pp. 51-54.

described by the Assistant Secretary. For example, does the cutback in progress payments hinder the achievement of this objective? Do cost disallowances, such as interest and certain of those disallowances recently legislated, burden the contractor's ability to modernize? Assistant Secretary Wade, for example, states that he is looking for ways to revamp and restructure existing programs and policies to further promote this objective of achieving manufacturing and productivity improvement. We commend him for his willingness to engage in this revamping and restructuring process, and he should be zealous in identifying conflicts between policies.

The acquisition workforce.—

> ". . . [T]here are a number of actions we can take to enhance our acquisition workforce. We must also instill all individuals (extending to defense contractor personnel) better discipline and a sense that it is 'our' money being spent and not someone elses. We also need superior, better qualified people. . . ."

I am sure that in a general sense industry agrees with this statement. It is appropriate on this point, however, to indicate that Congress seems to mandate the granting of superior authority to auditing personnel over the contracting officer. This trend is disturbing to industry and, we believe, to government contracting personnel. We are convinced it will be counterproductive in the long run and it does not contribute to the broad objective of acquiring superior, better qualified people in the contracting officer corps. Moreover, excessive preoccupation with audit and granting of superior authority to the auditor over the contracting officer may very well distract the defense contractor from some of the other objectives of the Congress and the procurement authorities, including the overriding goal of obtaining the highest quality product, on schedule, at a reasonable price.

At some point the Subcommittee should examine the responsibilities and interaction between project managers, contracting officers, and various levels of the auditing corps. I suspect that you would find, for example, that the growing domination of the auditors is forcing the contracting officer into a posture of no-risk—not a favorable development for the procurement system.

DOD/industry relationship.—

> "Much has been said about the proper relationship of the DOD and industry. It is usually characterized in terms of being too adversarial or too incestuous depending on one's viewpoint. We have to be very careful that neither extreme is a reality."
>
> "One concern I currently have is that we may be placing too much emphasis on the threat of criminal penalties. We don't want to end up in this situation where crooks are the only people willing to do business with the DOD—since they may be the only type oblivious to the risks."

This is a valid point articulated in an effective way.

Some Other Observations

Needed amendment of Overhead Cost Certificate.--The Overhead Cost Certificate, which was very badly drafted by DOD, has been the subject of interpretation and clarification in certain Department of Defense documents. The Certificate itself, however, has never been modified directly. There is no excuse for this failure on the part of the Department of Defense, and we urge that this Subcommittee or its staff encourage appropriate corrective action by DOD to spell out what is the current actual policy concerning this certification requirement.

Warranties.--The new statutory provisions on warranties appear to have eliminated most of the problems implicit in the enactment of the Andrews amendment. It should be mentioned, however, that there appears to be some feeling that there has been insufficient implementation of the new provisions by the Office of the Secretary of Defense, thus permitting the individual services to go their own way on this matter.

As a matter of fact, in general, certain individual service procurement policies are too independent of overall DOD policy guidance. This trend seems to be expanding and accelerating. If we are correct, a major DOD organizational issue is raised and it should be addressed by the Congress and the President's Blue Ribbon Commission on Defense Management.

Defense industrial base.--Let me make a few comments on this subject. I think only lip-service is being paid to this vital issue.

The Congress should be aware that subcontractors are a critical part of this base. Many of them not only manufacture essential products but in a large number of cases they have commercial alternatives. Overregulate them and at least some will leave the defense procurement chain. In this connection, if procurement people overdo the price factor in overseeing prime contractor placement of subcontracts, including pushing for foreign sources, the U.S. subs will, of course, be turned off.

Publication of proposed regulations.--Although technically speaking the Office of Federal Procurement Policy statute is not within the purview of this particular hearing, we offer a pertinent comment for the information of the Subcommittee. The provisions of the OFPP Act require that no procurement policy directive shall take effect until 30 days after it is published for comment in the Federal Register. However, there is provision for waiving the requirement if urgent and compelling circumstances make compliance impractical.

DOD used the exception to put the new overhead cost certification requirement into effect last March without prior public comment. Subsequently, DOD, together with NASA and GSA, used the exception with respect to the commercial pricing certification requirement and the other provisions included in FAC 84-10 and FAC 84-11. At this point, the exception has been used so often that it is close to becoming the general rule. At the minimum, what needs to be done is to make clear to DOD that the exception proviso should be used only in a limited manner and that, when used, the "urgent and compelling circumstances" should be clearly identified.

Commercial pricing for supplies.--There is a requirement that in noncompetitive contracts the offeror must certify in his offer that the price stipulated is not more than its lowest commercial price for the item. This provision was implemented on an interim basis in FAC 84-10. We have criticized this regulation and our recommendations are spelled out in Appendix B to this statement.

Conclusion

In conclusion, we emphasize, respectfully, that in our judgment the oversight objectives of this Subcommittee are difficult to achieve fully at this juncture with respect to legislation so recently enacted, not yet fully implemented, and not yet tested in the field in a practical way. We wish, however, to commend the Subcommittee for its continuing role in reviewing and testing legislation enacted in the defense procurement area. Moreover, we believe that it is the Armed Services Committee--and this Subcommittee particularly--which should exercise the primary oversight role in the Senate with respect to DOD's procurement policies and activities.

We emphasize our view, which the procurement authorities seem to share, that in the government interest, and in the interest of the defense contracting industry as it attempts to assist in the achievement of national security objectives of the United States, we have already had more legislation than we need.

Beyond the specifics of individual statutory enactments, their implementation, and regulatory initiatives undertaken by procurement authorities without reference to statutory mandates, we see an already existing and growing problem of substantial magnitude in the congressional oversight process as it relates to the defense program of the U.S., including procurement. There are so many committees, subcommittees, and congressional staff playing a role in the oversight process in the Congress that we have difficulty understanding how the Congress can effectively legislate in this area and how procurement officials can find the time to manage their responsibilities. The total number of procurement-oriented hearings and special congressional requests to procurement agencies for reports and other documentation are unbelievable in number and scope. This issue has been emphasized in a number of official documents, as in the Staff Report to the Committee on Armed Services of the U.S. Senate entitled "Defense Organization: The Need for Change" published under date of October 16, 1985. The point is also made in a private study entitled The Pentagon and the Art of War by Edward N. Luttwak./1

Finally, in our judgment, there is a central thrust missing in legislating, rule making, and congressional oversight in the defense acquisition area. There are numerous procurement objectives, many of them sound by themselves. However, in many respects these objectives are inconsistent or contradictory when viewed as a whole. Reconciliation of procurement objectives and procedures is seldom attempted either at the congressional or executive branch level. If this situation continues, the result will be very counterproductive.

MAPI appreciates the opportunity to appear in these hearings and stands ready to assist in any other way.

1/ The Pentagon and the Art of War by Edward N. Luttwak, Simon and Schuster, Inc., 1984.

Appendix A

MACHINERY and ALLIED PRODUCTS INSTITUTE
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October 8, 1985

Defense Acquisition Regulatory Council
ATTN: Executive Secretary, DASD (P-DARS)
c/o OUSDRE (M&RS) Room 3D139
Pentagon, Washington, D.C. 20301-3062

Dear Sir:

Proposed Defense Department Regulations Concerning
Contractor Rights in Technical Data

We wish to comment on the proposed regulatory implementation of the technical data provisions of the Defense Procurement Reform Act of 1984 (Title XII of the Fiscal Year 1985 Defense Authorization Act; P.L. 98-525) and the Small Business and Federal Procurement Competition Enhancement Act of 1984 (P.L. 98-577). Specifically, we address the proposed rule, denominated DAR Case 84-187, published in the Federal Register of September 10, 1985.

So you may understand the great importance of the rights-in-data issue to our membership, we wish to say a word about the Institute. The Machinery and Allied Products Institute (MAPI) is the national spokesman for a wide range of manufacturers and users of capital goods and allied products. In recent years, our membership has been substantially extended beyond manufacturers of traditional capital goods to include producers of electronics, telecommunications products, scientific and industrial instruments, office systems, aerospace equipment, computers, controls, testing equipment, military hardware, and similar high-technology product lines. Although most MAPI member companies are oriented towards commercial rather than government sales, many of them are indispensable to the government's requirements, particularly in national defense and related areas. These companies rely heavily upon continuing technological progress, the bulk of which is developed at the companies' own expense, to produce quality products and maintain their competitiveness. Therefore, they have a vital interest in continued recognition by the government of their proprietary rights in technical data relating to technological developments.

We believe that the proposed regulations do not properly implement the policy requirements of P.L. 98-525 and the proposed Federal Acquisition Regulation (FAR) coverage of technical data1/

1/ A notice of the proposed Federal Acquisition Regulation (FAR) coverage was published in the Federal Register of August 15, 1985. The policy provision is the only portion of the FAR coverage that applies to DOD.

because the proposed regulations are unfairly skewed in favor of the government. In fact, unfairness so pervades the regulations that the proposed rule should be withdrawn.

The following are major examples of such unfairness in the proposed regulations:

1. Cap on technical data rights.--P.L. 98-525 (10 U.S.C. 2320(c)) permits DOD to prescribe standards for employing as a negotiation objective the capping of contractors' rights in technical data. The proposed regulations (DOD FAR Supplement 227.473-2(e) and Alternate III to 252.227-7013) do not comply with Section 2320(c) because, while the regulations list four factors to be considered in determining the length of a cap, no factors are prescribed for making the basic determination of whether a cap should be a negotiation objective.

The absence of such standards indicates that DOD may attempt to obtain a contractor's rights in limited-rights data regardless of whether it is cost-effective for the government to do so and whether the data relates to commercial processes or products. In the latter case, there would be an inconsistency with Section 1202(6) of P.L. 98-525 which states that DOD shall "ensure that persons that have developed products or processes offered or to be offered for sale to the public are not required as a condition for the procurement of such products or processes . . ." to relinquish their rights in data relating to such products or processes.

2. Data relating to commercial products and processes.--The proposed regulations (DOD FAR Supplement 227.472(b)) implement Section 1202(6) in an unfairly narrow fashion by adding several requirements which the contractor must meet before DOD is precluded from requiring the relinquishment of data rights in a commercial product as a condition for a procurement. The proposed regulations state that commercial products or processes must be "existing" and sold, licensed or leased in "substantial quantities" at "established catalog or market prices." Further, Section 1202(6) is totally vitiated by the statement in Section 227.472(b) that an offeror's willingness to provide DOD appropriate rights in technical data relating to processes and products sold to the public may be evaluated as part of a source selection.

3. License rights.--The proposed regulations provide for both indirect licensing (DOD FAR Supplement 227.473-2(b) and Alternate IV to 252.227-7013) and direct licensing (DOD FAR Supplement 227.473-2(c) and 252.227-7036) of limited-rights data. The indirect licensing provisions do not appear to fairly protect the interests of the contractor which originated the limited-rights data. Alternate IV to Clause 252.227-7013 states that the government "assumes no liability for use, duplication, or disclosure of such data by others for commercial purposes," yet the proposed regulations do not require that contracting officers require the licensor to sign nondisclosure and non-use agreements that would allow direct enforcement by the originators of the data.

DOD FAR Supplement 227.473-2(c) states that direct licensing ". . . permits contractors to retain direct control over use of their limited and restricted rights data being transferred to the second source." However, this control and enforcement provided the licensor is vitiated by the terms of DOD FAR Supplement 252.227-7036 which states that the government will stipulate desired terms and conditions of any license and will review and approve all direct licensing agreements.

4. Definition of "developed at private expense".--The proposed regulations use the definition of "developed at private expense" as a vehicle for balancing the competing interests of the government and contractors in limited-rights data. However, the proposed regulations do not fairly balance such interests. Further, P.L. 98-525 requires that, in allocating rights in data, the regulations focus on the source of funding, whereas the proposed regulations allocate rights based on the circumstances under which an item, component, process or software package is "developed."

Because of the significance and complexity of the last example above, the remainder of this letter is dedicated to addressing the issues related to the proposed definition of "developed at private expense."

Definition of "Developed at Private Expense"

The Federal Register notice states that the phrase "developed at private expense" has been defined and that the definition establishes the legitimate proprietary interest of the contracting parties as required by P.L. 98-525 (10 U.S.C. 2320). While the proposed definition (found at proposed DOD FAR Supplement 227.471 and 252.227-7013) does establish the proprietary interest of the government and contractors, it does not achieve a fair and reasonable balance between the competing interests of the government and contractors in technical data as required by the conference report on the legislation./1

"Developed at private expense," as defined in the proposed regulations, "means that completed development was accomplished without direct Government payment, at a time when no Government contract required performance of the development effort, and was not developed as a part of performing a Government contract." To be consistent with Section 2320(a)(1) and to fairly balance the interests of the government and contractors in technical data, the preceding definition should end with a period after the word "payment." Without such a truncation of the definition, the government could claim unlimited rights in production processes that were specifically developed by a contractor to reduce its manufacturing costs on a fixed-price contract. Under certain circumstances, the government might also claim unlimited rights to an item that a subcontractor develops at its own expense.

For an item, component, process or computer software to be considered developed at federal expense, not only should the contractor have received direct federal funds, but also the contract should have included a line item requiring the development. This is consistent with the requirement in P.L. 98-525 (10 U.S.C. 2320(b)(4)) that separate contract line items be established for technical data and with the legislative history of the statute.

The legislative history of P.L. 98-525 shows that the conferees felt it was impossible to legislatively establish a balance of the competing interests of the government and contractors in technical data which would apply in all situations, and

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1/ Congressional Record, September 26, 1984, p. H 10303.

therefore they deferred to DOD on the issue./1 In the words of the conferees, ". . . the direction [in 10 U.S.C. 2320(a)] to the Department of Defense . . . to prescribe regulations defining the legitimate interests of the United States and of a contractor to be implemented in the system of government-wide procurement regulations will afford the best opportunity to reach a fair and reasonable balance of these competing interests. . . ."/2 As we indicate below, it seems clear that, despite the mandate from the congressional conferees, no such balance has been struck.

It appears that as part of the decision to allow DOD to draft regulations which would strike a balance in the rights to technical data for all cases, the conferees deleted the definition of "developed at private expense" which was included in the House version of the 1985 Defense Authorization bill (H.R. 5167). That definition, which originally came from H.R. 5064, the "Defense Spare Parts Procurement Reform Act," reads as follows:

> "Developed at private expense", as used in this clause, means with respect to an item (or technical data relating to an item) delivered under a contract, developed without direct payment by the Government under a provision of the contract which requires the performance of the development effort.

The above definition indicates that the House did not intend to change DOD's general policy on technical data because the definition merely recites the broad policy DOD has applied over the past 20 years--that is, only if there is direct payment by the government for the development work is an item, component, or process not to be considered developed "at private expense." It seems clear that the deletion of the House definition indicates only that the conferees felt that it would be better to have that concept drafted administratively by regulation.

Moreover, there is persuasive evidence that at least some DOD policymakers consider the above definition to be the proper reflection of DOD's general policy on technical data. The above legislative definition was adopted in the report, "Who Should Own Data Rights: Government or Industry? Seeking a Balance," submitted to the Under Secretary of Defense for Research and Engineering on June 22, 1984. The report, which was written by the OSD Technical Data Rights Study Group under the direction of Darleen A. Druyun, is referred to hereinafter as the Druyun report. It is apparent that the proposed regulations have adopted portions of the Druyun report.

While the above legislative definition may have been considered to be sufficient for a broad statement of DOD policy on technical data, the conferees apparently felt that a more detailed definition was required. We believe that P.L. 98-525 indicates the nature of the detail that DOD is to provide in its regulations. Specifically, 10 U.S.C. 2320(a) lists the following as one of the factors required to be considered by DOD in prescribing technical data regulations:

> (1) Whether the technical data was developed—
>   (A) exclusively with Federal funds;
>   (B) exclusively at private expense; or
>   (C) in part with Federal funds and in part at private expense.

1/ Ibid.

2/ Ibid.

However, the proposed regulations do not even address the issue of allocating proprietary interests in technical data developed in part with federal funds and in part with private funds as called for in 10 U.S.C. 2320(a)(1)(C). Whereas Section 2320(a)(1) indicates that the source of funding should be the basis for allocating technical data rights, the proposed regulations emphasize the concept of "developed." "Developed" was not even defined in the above legislative definition of "developed at private expense."

Definition of "Developed"

The proposed regulations define "developed" in the phrase "developed at private expense" in an attempt to further clarify the rights of contractors and government in technical data. Significantly, the definition of "developed" requires an item, component, process or computer software to "have been tested so as to clearly demonstrate that it performs the objective for which it was developed." We believe this definition unduly favors the government and should not be used.

We believe that "workability" is the current standard for determining whether an item, process, component or computer software is "developed."/1 Further, we believe that that standard should be retained because it establishes a fair and reasonable balance between the competing interests of the government and the contractors as required by P.L. 98-525. "Developed," within the concept of "workability," means that "an item, component, process or computer software is considered to be developed if it is brought to a point of development sufficient to demonstrate to one reasonably skilled in the art to which such item, component, process or computer software relates that it performs or can perform the purpose for which it was intended."/2

To "demonstrate" "workability"—

> . . . the item or component must be analyzed and/or tested sufficiently to demonstrate to reasonable persons skilled in the applicable art that there is a high probability the item or component will work as intended. Whether testing is required in addition to analysis, and the degree of testing and whether dynamic as well as static, depends on the nature of the item or component and the state of the art.
>
> * * *
>
> The required analysis and testing need not be enough to bring the item or component to the point where it would be sold or offered for sale if it were a commercial item. Again, further development may be necessary before the item or component would be ready to be sold or offered for sale, and such further development may require validation through further analysis and

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1/ Bell Helicopter Textron, 44 Federal Contracts Report (BNA) 648, 655 (Armed Services Board of Contract Appeals (ASBCA) No. 21192 Sept. 23, 1985).

2/ Ibid., pp. 650 and 655.

> testing. Also, . . . workability, . . . to a high degree of probability, which is enough for an item to be "developed" for data rights purposes, may not be enough to make the item or component ready to be sold or offered for sale; for that, 100 percent certainty would usually be required. . . .[1]

As indicated above, the concept of "workability," does not inflexibly require in all cases the testing of an item or component.[2] This is consistent with cases under the patent law relating to reduction to practice which have long held that there are items so simple that mere construction alone is all that is necessary to constitute reduction to practice.[3]

In fact, there may be rare cases where the item, component or process is so simple that its "workability" would be obvious without building a prototype.[4] This is consistent with early DOD policy on patent rights.[5]

Modifications to Items, Components, Processes and Computer Software "Developed at Private Expense"

The proposed definition of "developed at private expense" also addresses the issue of who has rights to the technical data when there is a federally funded modification to an item, component, process or computer software which was originally "developed at private expense." The proposed definition states that in such a case "modification of the item, component, process or computer software shall not be considered to have been developed at private expense." It is not clear from the preceding language whether the entire item, component, process or computer software or only the modified portion thereof would be considered to be developed at federal expense.

Another sentence in the definition of "developed at private expense," however, indicates that the modified portion would be the only part considered to be developed at federal expense. That sentence states that if "the entire item, component, process, or software package was not developed at private expense, separate elements thereof which do meet the criteria will be considered to have been developed at private expense."

It would be manifestly unjust and contrary to current case law if the government were to expropriate a contractor's technical data rights by virtue of a minor modification to an item, component, process or software package which was "developed at private expense." See Patents and Technical Data, Nash and Rawicz, pages 443-45, George Washington University (1983).

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[1] Ibid., p. 655.

[2] Ibid.

[3] Patents and Technical Data, Nash and Rawicz, p. 169, George Washington University (1983). See also MAPI's June 14, 1974 letter to Captain Leroy E. Hopkins, U.S. Navy, Chairman of the ASPR Committee, on the "Meaning of 'Developed' in Connection With Limited Rights Data."

[4] Bell Helicopter Textron, 44 Federal Contracts Report, p. 655.

[5] Ibid., p. 654.

Conclusion

We do not believe that the proposed technical data regulations fairly and reasonably balance the government's needs and the contractors' legitimate proprietary interest in technical data as required by P.L. 98-525 (10 U.S.C. 2320(a)) and proposed FAR 27.402, "Policy." While we have noted other problems with the proposed regulations, we are particularly concerned that the proposed definition of "developed at private expense" would significantly and unfairly narrow contractors' rights in technical data and computer software.

As reflected in Section 2320(a)(3) and FAR 27.402, the government has an interest in obtaining rights in data in order to increase competition and lower costs by developing alternative sources of supply and manufacture. On the other hand, Section 2320(a)(4) and FAR 27.402 indicate that contractors' economic position, especially their commercial position, must be protected to encourage qualified contractors to participate in government programs and apply innovative concepts to such programs.

The proposed definition of "developed at private expense" is so skewed in favor of the government that many contractors would be discouraged from participating in government programs and applying innovative concepts. Further, we do not believe that the proposed definition properly reflects congressional intent as manifested by the definition of "developed at private expense" which was included in the House version of the 1985 Defense Authorization bill. The same definition was also included in the Druyun report.

Moreover, we believe that 10 U.S.C. 2320(a)(1) requires DOD to focus, in the technical data regulations, on the issue of the source of funding, not the "development" of an item, component, process or software package. But if "development" is to be emphasized, "workability" should be the standard for determining whether an item, component, process or software package has been "developed."

The proposed definition should be clarified to indicate that a federally-funded minor modification does not give the government unlimited rights in an item, component, process or computer software that was originally "developed at private expense."

Finally, although we have offered these specific suggestions, as indicated at the outset it is MAPI's overall judgment that the proposed regulations are so lacking in balance and fairness that they should be withdrawn.

This concludes our comments on the proposed technical data regulations concerning the term "developed at private expense" in connection with limited-rights data. If we can be of further assistance, please let us know.

Sincerely,

Charles Stewart

President

cc: Dr. James P. Wade
Assistant Secretary of Defense
(Acquisition and Logistics)

Appendix B

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August 8, 1985

General Services Administration
ATTN: FAR Secretariat [VR]
Room 4041
18th and F Streets, N.W.
Washington, D.C. 20405

To Members of the Secretariat:

(FAC 84-10)

Interim Regulations Relating to the
Commercial Pricing Certification Requirement

This is in response to the notice in the Federal Register of July 3 requesting comments from interested parties on Federal Acquisition Circular (FAC) 84-10 which took effect on an interim basis on July 3. The Circular has now been reviewed by those companies within the Machinery and Allied Products Institute (MAPI) membership which have a significant stake in government contracting. The discussion and recommendations which follow are based on this review by member companies and on analysis by the MAPI staff.

Specifically, our comments are directed to Item III, Certification of Commercial Pricing, which implemented Section 1216 of Public Law 98-525 (the Defense Procurement Reform Act) and Section 204 of Public Law 98-577 (the Small Business and Federal Procurement Competition Enhancement Act).

Applicability to Spare and
Replenishment Parts

Under FAR 15.813-1 as added by FAC 84-10, the new statutory commercial pricing certification requirements have been made applicable to contracts for "items of supply." We think that in view of the legislative history of the statutory requirements, the scope of application of the requirements is too broad. It seems clear from the provisions of the separate House and

MACHINERY & ALLIED PRODUCTS INSTITUTE AND ITS AFFILIATED ORGANIZATION, COUNCIL FOR TECHNOLOGICAL ADVANCEMENT, ARE ENGAGED IN RESEARCH IN THE ECONOMICS OF CAPITAL GOODS (THE FACILITIES OF PRODUCTION, DISTRIBUTION, TRANSPORTATION, COMMUNICATION AND COMMERCE) IN ADVANCING THE TECHNOLOGY AND FURTHERING THE ECONOMIC PROGRESS OF THE UNITED STATES

Senate bills which resulted in the new statutory requirements, that the intendment of the draftsmen of these provisions was to impose a new statutory certification requirement on contracts for the procurement of replenishment and spare parts, rather than on contracts for all items of supply generally.

We acknowledge that the statutes use the broad term "items." But we also note that the Joint Explanatory Statement of the conferees on this provision, after referring to the original provision addressed to "spare or replacement parts" in the House bill, states that "minor clarifying changes" have been made in the original House provision. Under these circumstances and in view of this legislative history, we think it makes more sense to construe the term "items" in the statute as referring to items of spare or replenishment (or replacement) parts rather than to items of supply generally. For that reason, we recommend that, as a matter of administrative discretion, the FAR implementation of the statutory requirement for commercial pricing certification be limited to contracts for spare or replenishment parts.

Application to Contract Types

FAR 15.813-5 provides that the Certification of Commercial Pricing clause should be inserted in all solicitations and contracts "unless exempted under 15.813-3(a) or (b)(1)." FAR 15.813-3 is entitled "Exemptions From Commercial Pricing Certificates." The difficulty here is that FAR 15.813-2, "Applicability," includes a number of criteria, not referenced in FAR 15.813-3, as to when the clause should be used. For example, FAR 15.813-2(1) states that the certificate is to be required in connection with contracts not awarded on the basis of full and open competition. Obviously the reverse of that proposition is important--the certificate is not to be required, and presumably neither should the clause be required, in connection with contracts that are awarded on the basis of full and open competition. In general then, the language included in FAR 15.813-5, relating to when the contract clause is to be used, should be expanded to refer to the criteria included in FAR 15.813-2, "Applicability," as well as the appropriate language in FAR 15.813-3, "Exemptions From Commercial Pricing Certificates."

Recognition of the Role of Original Equipment Manufacturers

The certification of lowest price does not recognize prices to original equipment manufacturers (OEMs) and dealers who add either product or marketing value and resell to end user customers. Such recognition, in our view, is necessary in order to prevent a misunderstanding on the part of those in government who have the responsibility of administering these provisions. Obviously, such sales to OEMs and dealers are sales in which either the items themselves or the circumstances under which they are sold are not comparable to the government sales at issue.

Need for Audit Limitations

Paragraph (b) of the certificate form, prescribed by FAR 52.215-32, gives the contracting officer (or representatives of the contracting officer who are employees of the government) the right "to examine and audit all books, records, documents and other data of the Contractor relating to the pricing of the commercial items covered by this offer/proposal." We think that such audit authority is far broader than is actually needed for the purposes of verifying data provided by the contractor with respect to selling prices in sales of the commercial items in question to other customers. The provision should be revised to specify that the government's audit access is limited to the information that is needed for this purpose, and does not include access to information relating to the costs of producing the commercial items.

Need for Floor on Data

Finally, there is a need to establish a de minimis figure on sales to nongovernment parties and persons that must be taken into consideration in determining whether the government has been offered the lowest commercial price for the item in question. Without such a de minimis amount being specified, we are concerned that the requirement for providing such data with respect to other customers can become a nearly impossible administrative burden.

* * *

This completes our comments on FAC 84-10. If we can be of any further assistance, please let us know.

Cordially,

Charles Stewart

President

Statement Prepared by
Alexander Kirk
for the Chairman and Members
of the Subcommittee
on General Oversight and Investigations
of the House Committee on
Banking, Finance, and Urban Affairs

My name is Alexander Kirk and I am consultant to defense contractors. I was engaged in the general field of renegotiation from 1942 to 1949 and from 1953 to 1954 as a government official. I then became a renegotiation consultant to industry from 1954 to the termination of the Renegotiation Board a few years ago. Since then I have kept some of my former clients advised on developments in defense procurement.

Based on this experience of many years, I am convinced that sooner or later some form of renegotiation will be adopted by Congress to help cure the many existing problems of defense procurement. The important question is what form the future renegotiation should take. In this connection I would urge that the type of renegotiation, conducted during the Second World War, namely under the Acts of 1942 and 1943, preferably the latter, be given careful consideration. I believe that comparatively little is known about this wartime operation and, in fact, I have found that some members of both Houses of Congress do not realize that there was such a thing as renegotiation prior to the enactment of the Renegotiation Act of 1951. Actually, wartime renegotiation was on a far larger scope than under the Act of 1951.

As the attached letter from the Assistant Secretary of the Army, Gordon Gray, will indicate, I was a member during the war of what was then termed the War Department (later Army) Price Adjustment Board, which handled all renegotiation activities of the Army and Army Air Force, or approximately 80% of all renegotiation conducted during the war. There were other such boards during this period. The Navy had one and so did the Maritime Commission, the Reconstruction Finance Corporation, and the Treasury Department. Superimposed on all these operational boards was the War Contracts Price Adjustment Board, which consisted of the chairmen of all the operational boards. The latter, however, confined its functions entirely to matters of policy, and did not participate in any of the case renegotiations. Both the War Department (Army) and the Navy had quite a number of regional offices and boards throughout the country where most of the settlements were made. Only the so-called impasses were handled by the top boards in Washington. Shortly after the war, there was the so-called Act of 1948 (which was very limited in scope and had little influence on procurement).

While the Act of 1943 (by far the better of the wartime acts) was taken as a model for that of 1951, whose revival, with certain added procedures, is advocated by H.R. 3020, there was a great difference in the emphasis on the basic purposes of renegotiation between the two Acts. The 1943 Act stressed the importance of the prices paid by the Armed Forces for the goods and services needed, whereas the 1951 Act concentrated entirely on the recapture of alleged excessive profits from contractors. In my opinion the 1943 Act better interpreted the primary purpose of procurement, which was to obtain the highest quality of goods and services at the lowest possible prices than did the 1951 Act.

The very name of the wartime renegotiation boards indicated their main function was that of price adjustment. The basic concept of renegotiation was to protect the American taxpayer from the over-pricing of the materiel of war. There was no reference to profits. It was, in effect, a retroactive repricing process. Internal Revenue Service confirmed this by reducing sales as well as profits in making renegotiation adjustments for income tax purposes.

The renegotiable profits of contracts, were, of course, considered in wartime renegotiation. They were, however, for the most part, a secondary matter. Sometimes the recapture of renegotiable profits were the only means of renegotiation such as in situations in which there was a sole source of supply, and where there were no competitive prices. As I understand it, there could be many of these sole-supply situations today wherein the primary purposes of the two Acts would be identical. Generally, however, under wartime renegotiation, it was felt that a contractor or subcontractor whose products were of high quality, which met production schedules, and kept its prices at as low or lower than its competitors, deserved the best treatment possible. This meant that contractors of this type could retain their realized profits even though these profits were higher than those normal for the particular industry. In other words, we felt that the efficient contractors should be rewarded. It has been my experience that so often, the efficient contractor had both the lowest prices and the highest profits. Assessing refunds against these same contractors, only because of the high profits, always seemed to me to be discouraging efficiency.

One of the chief administrative distinctions between wartime renegotiation and the 1951 Act was that the former was conducted within the specified departments and agencies, whereas, under the 1951 Act, it was established as an independent agency subject only to the authority of the President. I always considered the latter a bad mistake. The Renegotiation Board was a very small agency and had little influence in obtaining necessary funding. Furthermore, it became a political football. At every change of administration, new board members were appointed, more as a reward for their contributions to the party than for their financial experience. In my opinion, this led to some very bad settlements.

On the other hand, wartime renegotiation attracted for the most part the best industrialists, bankers, investment bankers, attorneys, accountants and salesmen. I realize that this reflected the patriotic appeal in wartime for many men not suitable for combat. With the proper incentives, however, I believe it could be duplicated today. For one thing, under today's set-up, with all the Armed Forces a part of D.O.D., it would require only one board of the wartime type to do the job, within the D.O.D. organization.

I have heard, of course, of the terrible consequences of putting the fox in the chicken house, which would occur if renegotiation were placed within D.O.D. It was not that way under the wartime Acts which lasted from 1942 to 1949. I was there all that time. In fact, the various named departments and agencies pursued renegotiation most vigorously or the job would never have been completed. Furthermore, those of us in the Pentagon had the distinct advantage of being able to find out the entire records of contractors by looking at their files. Under the 1951 Renegotiation Board set-up, a formal request for information on a contractor's record had to be made by the Renegotiation Board to D.O.D. The forthcoming answers were often not adequate and, in some cases, inaccurate.

I think it should be emphasized that wartime renegotiation was a successful operation. Many contractors after the war were glad to tell their customers and the public-at-large that they had been renegotiated and had made no financial "killing" out of the war. In my opinion, the fundamental reason for this was that wartime renegotiation addressed the essential procurement goal of trying to see that the government obtained the goods and services needed at the lowest possible prices. Directives were established to favor efficient procedures and penalties were established to hurt the inefficient. On the other hand, the renegotiable profits of contractors, generally speaking, were not the main focus of wartime renegotiation.

I am, therefore, recommending for your consideration the creation of a renegotiation board, based on the same principles as the wartime renegotiation boards. I think it would be helpful in solving many of the problems of defense procurement today. Some examples of this are the following:

(1) The procurement function would be strengthened. There has been much talk about upgrading the procurement officers in D.O.D. and that is all to be good. No matter how competent they are, however, they cannot foresee what might happen to the price situation in longer term contracts and subcontracts. I believe that only a permanent board, whose primary function is to see that the D.O.D. buys what it needs at the lowest prices, can deal successfully with this problem.

(2) There have been many horror stories about the exhorbitant prices of spare parts. These caused much public indignation. Three large contractors have made offers under certain conditions to make refunds to the government on spare parts business, which is a good move but does not begin to take care of the spare parts picture. As you know, D.O.D. officials and representatives of industry have been meeting to begin designing the industry-wide refund program ordered by Secretary Weinberger. I would suggest that the creation of a renegotiation board of the wartime type would be the best means of determining what prices were reasonable for spare parts and by what margin prices were excessive, sometimes a very tricky question. Furthermore, if the renegotiation board were given authority over the pricing of spare parts, it would seem only natural for it to have authority over the pricing of all goods and services purchased by D.O.D.

(3) Substandard products have been one of the chief worries of defense procurement. The only recourse of the government in many of these situations is to threaten law suits in the courts with all the unfortunate publicity and with no assurance of success. During wartime, renegotiation handled this problem very expeditiously. The quality of all merchandise and services was assumed to be excellent. If it was found to be substandard, it was classified as over-priced. The refunds demanded of contractors with overpriced merchandise

very often resulted in heavy losses for the contractors. The smart ones soon found that it was much to their own benefit to deliver only the highest quality goods and services.

(4) There have been complaints from GAO that many new defense weapons systems have been put into production before adequate testing had been finished, with most unfortunate results. Under the present system, this is understandable, because all funds spend by D.O.D. on R&D are gone forever, and these expenses can be heavy. With a wartime type of renegotiation board determining the reasonableness of the pricing of all elements of R&D, some of these funds would be refunded to the government. Under such conditions, D.O.D. should be more willing to spend adequate amounts for proper testing.

(5) A renegotiation board of the wartime type would be in a better position to determine proper overhead rates than the D.C.A.A. because of its examination of every element in a contractor's business on a fiscal year basis. If after such examination, the contractor's overhead rates were considered too high by a certain amount in dollars, the contractor's products were determined to be overpriced by the same amount of dollars. This often resulted in substantial refunds. This would also eliminate the need of the Defense Inspector General from issuing subpoenas. The latter procedure would be vested in a wartime type of renegotiation board.

(6) There are stories that the Air Force cited that certain contractors made price mark-ups on defense goods which were 200% to 600% greater than non-defense manufacturing prices for the same articles. Under the present system, the money has been spent by the government and there is no legal way to demand any type of reimbursement. Under the wartime set-up, with renegotiation in control of pricing, those same contractors would have been penalized so severely, they would never repeat this practice again.

I could list several other direct advantages to the creation of a wartime type of renegotiation board whose main function would be to see that D.O.D. purchased the best goods and services it needs at the lowest possible prices. I am refraining from doing so in this statement in the interests of saving time.

Respectfully submitted,

Alexander Kirk

Alexander Kirk

Attachment

DEPARTMENT OF THE ARMY
OFFICE OF THE ASSISTANT SECRETARY
WASHINGTON, D. C.

17 January 1949

Mr. Alexander Kirk
Department of the Army
Office of the Assistant Secretary
Washington, D. C.

Dear Mr. Kirk:

It is with regret that I accept your resignation as a Member of the Army Price Adjustment Board effective, 15 February 1949.

Your superior service, in this important activity is appreciated by the Department of the Army.

I wish you many years of good health and happiness.

Sincerely yours,

Gordon Gray

Gordon Gray
The Assistant Secretary of the Army